REAL PROPERTY | TRUST & ESTATE LAW

ABA SECTION OF REAL PROPERTY TRUST & ESTATE LAW

e|Report

A Bi-Monthly Electronic Publication for Section Members

April 2009

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Section News

It is Not Too Late to Register for the 20th Annual Spring Symposia
On-site registration will be held from 1:00 a.m. to 5:00 p.m. on April 29, and from 7:00 a.m. to 5:00 p.m. on April 30 and May 1 at the Fairmont Hotel RPTE Symposia registration desk. For more details about the Spring Symposia, visit www.abanet.org/rpte/2009/.

Be Sure to Attend One of Our Informative Luncheons at the Spring Symposia:
Real Property Luncheon - Thursday, April 30, 11:45 a.m. - 1:30 p.m.
"Can We Regulate the U.S. Financial and Housing Markets Back to Health? What we have learned and what we need to do."

Trust and Estate CLE Teleconference Luncheon - Thursday, April 30, 12:00 p.m. - 1:30 p.m.
"Hot Topics for Estate Planners" - This program will be simulcast as a CLE teleconference.

And do not miss the Diversity Breakfast and CLE Program on Friday, May 1, from 7:00 a.m. - 8:30 a.m.
"Eliminating Bias in the Profession: Why Aren't Law Firms and Corporate Law Departments Achieving Greater Success?"

In addition, first time minority bar members can attend the Symposia FREE of charge.

Real Property News Trust and Estate News

Real Property News

Tennessee Supreme Court Reverses Lower Court Ruling that Initiation of Foreclosure is "Increase in Hazard"

Technology and Law Practice Management

The Paperless Law Office: Creating an Electronic Closing Binder
Learning how to create an electronic closing binder using Adobe Acrobat Professional can help lawyers use less paper and reduce the cost of doing business, while providing additional value to clients.
Tonya Johnson

CLE Spotlight

Real Property CLE
Aftershocks: Reverberations of the Economic Downturn on Commercial Real Estate Finance
Date: Thursday, April 30, 2009
Time: 8:00 a.m. - 9:45 a.m. Eastern
Place: Fairmont Hotel, Washington D.C. (Spring Symposia)

Trust and Estate CLE
Estate Planning in Economically Turbulent Times
Date: Friday, May 1, 2009
Time: 8:45 a.m. - 9:45 a.m. Eastern
Place: Fairmont Hotel, Washington D.C. (Spring Symposia)

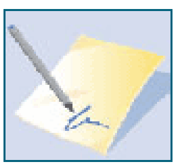
Group & Committee News

International Tax Planning Committee
Volunteer to Work On Current Projects!

Under Insurance Contract
Allison E. Graves
Allison Graves previously wrote for the *eReport* on a Tennessee lower court case finding that commencement of foreclosure was an increase in hazard under a property insurance policy. Allison updates our readers on the Tennessee Supreme Court decision overturning the lower court case.

"Springing Recourse" Guaranties Enforced in Recent District Court Opinions: Will The Trend Continue? Should In Terrorem Provisions Be Enforced?
James H. Wallenstein
Springing guaranties and nonrecourse carve outs will be getting a close look by lenders and the principals of borrowers in these tough economic times. Jim Wallenstein offers a thought provoking view from the guarantor's side of the loan transaction.

International Guaranties
Sidney G. Saltz
A real estate transaction, such as a lease, may be backed by a guaranty from a foreign company. Sid Saltz covers the issues counsel should look for in negotiating a foreign guaranty.



Trust and Estate News

Trusts, Estate Planning And The Family Jet
Michelle M. Wade and Dillon L. Strohm

Where There's a Will, There's a . . . Duty?: A Closer Look at the Safekeeping of Clients' Original Estate Planning Documents
Jennifer A. Kosteva

Charitable Strategies for Trust Beneficiaries
Sharon L. Klein and Henry S. Ziegler

New Voluntary Disclosure Procedure For Offshore Accounts
Gideon Rothschild

Recent Valuation Case Summaries
John H. Hardwick, Jr.

***Estate of Jorgensen*, T.C. Memo. 2009-66**

The International Tax Planning Committee is currently working on several projects of importance to practitioners and their clients. For more information, click here.

Diversity Committee
Become a Speaker!

The Diversity Committee is searching for diverse speakers to add to the RPTE speaker database on real property and estate planning issues. If you would like the opportunity to become a Section speaker, please contact Nelse Schreck, NSchreck@rodey.com.

TRUST AND ESTATE
The Charitable Planning and Organizations Group has had an active 2009 so far and expects the pace to continue throughout the rest of the year. To find out more about the Group's happenings, click here.

Elder Law, Disability Planning and Bioethics Group
The Social Security Administration has recently issued long-awaited guidance on the use of Special Needs Trusts for disabled beneficiaries. Click to learn more.

REAL PROPERTY
Residential, Multi-Family, Special Use Group
Given the state of the housing market, the Residential, Multi-Family and Special Use Group has been busy this Spring. View the Group's activities here.

Practice Management Group
The Practice Management Group has ongoing activities involving technology, pro bono, dispute resolution and ethics. At the upcoming Spring Symposia in D.C., the Group is focusing on the residential foreclosure crisis and concerns about the Interstate Land Sales Full Disclosure Act. Click to learn more.

Young Lawyers Network

Become involved in the substantive work of the RPTE Section by applying for the 9th annual Fellows Program. Do not miss out; the deadline is June 20th. For more details click here.

Section 2036 Applied to Creation of FLPs; Equitable Recoupment Allowed to Adjust for Prior Income Tax Overpayments in Light of Increase in Basis Attributable to Increased Gross Estate Value
Steve R. Akers

Employers Must Begin Using New I-9 Form April 3, 2009;
Federal Government Contractor E-Verify Requirements Take Effect May 21, 2009
Cynthia Marcotte Stamer

Join a Committee Today!

RPTE members can join a group or committee (or several) online at www.abanet.org/rpte/join. For questions regarding membership, contact the Section at (312) 988.5651 or email Bunny Lee at leeb@staff.abanet.org.

Would you like to write an article for the eReport?

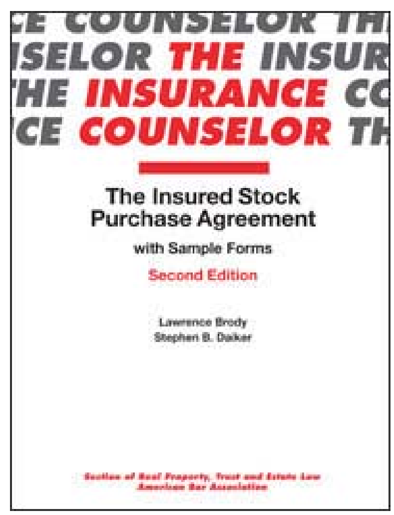
If you have something to say, and would like your article considered for the eReport, simply email Susan Talley, Editor, at stalley@stonepigman.com for further details.

Law Students

The June 20th deadline for the Section's Law Student Writing Contest is fast approaching! Do not miss out on your opportunity to become a recognized author. Click here for more information on the competition.

New Book from RPTE

The Insured Stock Purchase Agreement: With Sample Forms, Second Edition
Lawrence Brody, Stephen B. Daiker



Now completely revised and updated, The Insured Stock Purchase Agreement explains how a stock purchase agreement can be a successful tool for ensuring the harmonious continuation of the closely held corporation and solving the estate planning problems of its stockholders. The book details how a properly drafted and funded stock purchase agreement can accomplish these important planning objectives...Click here to learn more...

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- PDF of Real Property articles only

About RPTE eReport

The **RPTE eREPORT** is the bi-monthly electronic publication of the Real Property, Trust and Estate Law

Section. It includes practical information for lawyers working in the real property and estate planning fields, together with news on Section activities and upcoming events. **RPTE eREPORT** also provides resources for young lawyers and law students to succeed in the practice of law. For further information on **RPTE eREPORT** or to submit an article for publication, please contact: Susan Talley (Editor) at stalley@stonepigman.com; Cheryl Kelly (Real Property Editor) at CKELLY@thompsoncoburn.com; Robert Steele (Trust and Estate Editor) at steele@whafh.com; or Michael Goler (Managing Editor Emeritus) at Goler@MillerGolerFaeges.com. We welcome your suggestions and submissions.

The materials contained herein represent the opinions of the authors and editors and should not be construed to be those of either the American Bar Association or The Section of Real Property, Trust and Estate Law unless adopted pursuant to the bylaws of the Association. Nothing contained herein is to be considered as the rendering of legal advice for specific cases and readers are responsible for obtaining such advice from their own legal counsel. These materials and any forms and agreements herein are intended for educational and informational purposes only. The authors and other contributors to **RPTE eREPORT** are solely responsible for the content of their submissions, including the accuracy of citations to legal resource materials.

ABA Defending Liberty Pursuing Justice

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UPDATE:
TENNESSEE SUPREME COURT REVERSES LOWER COURT RULING THAT INITIATION OF FORECLOSURE IS "INCREASE IN HAZARD" UNDER INSURANCE CONTRACT

By Allison E. Graves[1]
Thompson Coburn LLP
www.thompsoncoburn.com

In a recent decision, the Tennessee Supreme Court reversed a Court of Appeals ruling holding that a mortgagee is required to give notice of the commencement of foreclosure proceedings to an insurer as such proceedings constitute an "increase in hazard" under both the standard mortgage clause in an insurance policy and Tennessee Code § 56-7-804.[2] In reversing this holding, the Supreme Court found that the plain and ordinary meaning of the term "increase in hazard" does not include an increase in a moral hazard, such as the commencement of foreclosure proceedings. Thus, failure to notify the insurer of the initiation of foreclosure proceedings will not invalidate a mortgagee's protection under an insurance policy absent a clear contractual provision to the contrary. *U.S. Bank, N.A. v. Tenn. Farmers Mut. Ins. Co.*, No. W2006-02536-SC-R11-CV, 2009 WL 199856 (Tenn. Jan. 29, 2009).

U.S. Bank, N.A. ("U.S. Bank") held a mortgage on certain residential real estate. The mortgagor obtained a Personal Fire and Extended Coverage Insurance Policy (the "Policy"), listing U.S. Bank as mortgagee, from Tennessee Farmers Mutual Insurance Company ("Tennessee Farmers"). The Policy contained a standard mortgage clause (the "Clause"), under which Tennessee Farmers agreed to protect U.S. Bank's interest in the insured property and that such protection would not be cancelled due to, among other things, an increase in hazard of which U.S. Bank was unaware. In return for this protection, the Clause required U.S. Bank to notify Tennessee Farmers of any increase in hazard of which U.S. Bank did have knowledge. Nothing in the Policy specifically required U.S. Bank to notify Tennessee Farmers of the commencement of foreclosure proceedings against the mortgagor.

After the mortgage went into default, U.S. Bank initiated foreclosure proceedings and notified the mortgagor of such through various letters sent by both U.S. Bank and its attorneys. Tennessee Farmers was not so notified. The foreclosure proceedings were stayed after the mortgagor filed for bankruptcy and were never completed. The house was destroyed by fire approximately six months later.

U.S. Bank subsequently submitted a claim to Tennessee Farmers under the Policy, and Tennessee Farmers refused to pay. Following this refusal, U.S. Bank filed a lawsuit against Tennessee Farmers alleging, among other things, breach of contract and arguing that Tennessee Code § 56-7-804 (the "Statute") prohibited Tennessee Farmers from refusing to pay U.S. Bank's claim based on the occurrence of foreclosure. The Statute contains almost identical language to the Clause. The trial court granted U.S. Bank's motion for partial summary judgment as to the effect of the Statute. The Court of Appeals

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[2] An article on the Tennessee Court of Appeals opinion in this case appeared in December 2008's edition of the ABA Real Property, Trust and Estate Law Section *eReport*.

reversed the trial court, holding that the initiation of foreclosure proceedings constituted an increase in hazard under both the Clause and the Statute such that U.S. Bank's failure to notify Tennessee Farmers of the foreclosure proceedings constituted grounds for invalidation of the Policy. The Tennessee Supreme Court agreed to hear U.S. Bank's appeal of the Court of Appeal's decision.

On appeal, the Court began its analysis of both the Clause and the Statute by setting out the general rule that, in the absence of ambiguity, the terms of a contract and the language of a statute should be given their plain and ordinary meaning. *U.S. Bank*, 2009 WL 199856 at *3. The Court then addressed the specific issue of whether the commencement of foreclosure proceedings was an "increase in hazard" of which U.S. Bank was required to provide notice to Tennessee Farmers or risk invalidating its coverage under the Policy. *Id.* at *4-*5. In reviewing similar cases from other jurisdictions, the Court found that other courts have generally held that foreclosure proceedings alone do not constitute the type of increase in hazard that requires notice to the insurer by the mortgagee. *Id.* at *5-*6. Courts have typically reached a different result only where the insurance contract specifically requires the mortgagee to provide notice of foreclosure proceedings to the insurer. *Id.* at *6. Based on those cases, the Court concluded that the plain and ordinary meaning of the Clause did not require U.S. Bank to provide notice of the initiation of foreclosure proceedings to Tennessee Farmers. *Id.* The Court observed that requiring such notice, in the absence of a specific foreclosure notice provision, would be the equivalent of the Court's rewriting the Policy, which is not an appropriate judicial function. *Id.* at *7. Therefore, U.S. Bank's failure to provide notice of the initiation of foreclosure proceedings to Tennessee Farmers did not void the Policy for failure to provide notice of an increase in hazard. *Id.*

As the language of the Statute parallels that of the Clause and creates the same protections and obligations, the Court found there to be no substantive difference between the two and found no reason to construe the two differently. *Id.* at *8. As with the Clause, the Court held that the plain and ordinary meaning of the phrase "increase in hazard," as used in the Statute, does not include moral hazards, which are increases in the risk that the mortgagor will destroy the insured property with the intention of collecting the insurance proceeds. *Id.* at *9. The commencement of foreclosure proceedings is one such moral hazard. *Id.* Rather, increases in hazard under the statute include only physical hazards, which are changes in the use or physical condition of the insured property that increase the risk assumed by the insurer. *Id.* Just as the Court declined to judicially rewrite the Policy, it also declined to amend the Statute judicially by expanding the plain and ordinary meaning of the phrase "increase in hazard" to include moral hazards. *Id.* Thus, a mortgagee is not required by either the Statute or a standard mortgage clause to provide notice to an insurance company of the commencement of foreclosure proceedings in the absence of a specific policy provision to the contrary. *Id.*

Although the Tennessee Supreme Court ruled favorably for the mortgagee in this case, the lower court's ruling cites decisions from other jurisdictions supportive of that court's position. Whether this latest Tennessee decision will inspire insurance companies to include language in their polices specifically identifying commencement of foreclosure as an "increase in hazard" remains to be seen. Where a provision in the insurance contract clearly identifies foreclosure as an increase in hazard, a casualty occurring during an unreported foreclosure may not be covered. Mortgagees should recognize that various circumstances may impair their casualty coverage and provide written notice of known circumstances which fall or may fall within the category of an "increase in hazard" to the insurance company.

"SPRINGING RECOURSE" GUARANTIES ENFORCED IN RECENT DISTRICT COURT OPINIONS: WILL THE TREND CONTINUE? SHOULD *IN TERROREM* PROVISIONS BE ENFORCED?

by James H. Wallenstein[1]
Hunton & Williams LLP

This article updates two excellent papers that have recently been presented by RPTE eReport Real Property Editor Cheryl Kelly.[2] In fact, the impetus for this article is my having requested an update from Editor Kelly and then "volunteering" when she suggested that I perhaps provide for eReport an analysis of the two cases to which she alerted me in her update.

<u>Two Recent District Court Opinions on the Topic of "Springing Recourse"</u>

111 Debt Acquisition LLC v. Six Ventures, Ltd. et al., No. C2-08-768, U.S. District Court, S.D. Ohio, Eastern Division, Opinion and Order dated February 18, 2009, and published at 2009 WL 414181. In November 2006 Six Ventures, Ltd. refinanced six apartment projects with a $20,900,000 mortgage loan. The mortgage loan was non-recourse, meaning that the mortgagee could not pursue the borrower for a deficiency judgment after foreclosure; however, a guaranty executed by three guarantors provided that although their initial status with regard to the loan was also non-recourse, their status would convert to a full-recourse liability for the entire loan balance upon a "Springing Recourse Event," one of which was the borrower's filing for bankruptcy. In September 2008, after having defaulted in its mortgage payments, Six Ventures, Ltd. filed for bankruptcy. In October 2008 the bankruptcy court granted the mortgagee relief from the automatic stay, thus allowing the mortgagee to proceed with foreclosure against the properties. The borrower's bankruptcy filing, though, prompted the mortgagee to sue the guarantors for the full balance of the $20,900,000 loan, claiming that the bankruptcy filing was a "Springing Recourse Event" under the guaranty. In an Opinion and Order dated February 18, 2009, the District Judge in the *Six Ventures, Ltd.* litigation granted the mortgagee's motion for partial summary judgment, holding that the guarantors were liable for the full balance of the $20,900,000 loan. In his opinion the District Judge analyzed (i) whether or not the "Springing Recourse Event" provision in the guaranty and other loan documents was clear (in a quite extensive analysis, he found that it was clear), (ii) whether the mortgagee had followed proper trial procedure (he found that the mortgagee had done so), and (iii) whether the guaranty provision violated public policy by discouraging debtors from filing for bankruptcy protection (he found that it did not violate public policy). However, the District Judge's Opinion and Order contains no discussion of whether the springing recourse provisions, which in this instance would cause the guarantors' liability to increase from zero to an amount approaching $20,900,000, might have prescribed an unenforceable "penalty" since the effect of the borrower's prohibited action appears to have resulted in nothing more than an approximately one-month delay in the mortgagee's foreclosure process.

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[1] JAMES H. WALLENSTEIN is a Counsel in the Dallas office of Hunton & Williams LLP, with his resume being printed at www.hunton.com/bios/bio.aspx?id=17400&tab=0013. He can be reached at (214) 468-3391 or by e-mail at jwallenstein@hunton.com. Especially in light of the admittedly editorial tone of some of the author's analysis, he makes the following disclosure and disavowal: (1) the author's clients are predominantly real estate developers and investors, i.e., not mortgage lenders; and (2) the author's comments are solely his personal observations and conclusions, and they in no way represent the views of his law firm or any clients of his law firm.

[2] Kelly, *Real Estate Work-Outs: Running Dry in the Liquidity Crunch?* June 19, 2008 Telephone Seminar/Audio Webcast sponsored by the American College of Real Estate Lawyers, printed at the following internet web page: http://files.ali-aba.org/thumbs/datastorage/skoobesruoc/pdf/TSNR01_chapter_02_thumb.pdf , which in turn updates Kelly, *Enforcement of Guaranties Including Carve Outs from Recourse Liability and Springing and Exploding Guaranties*, ACREL Fall 2007 Meeting presentation.

Compare *FDIC v. Prince George Corporation*, 58 F.3d 1041 (4th Cir. 1995), which was decided under a different form of limited guaranty provision, i.e., so-called "carve-out" liability for actual losses instead of springing liability on the entire loan amount, and which shows that a court can determine the actual loss that a lender incurs when the borrower violates the no-bankruptcy provisions in loan documents.

CSFB 2001-CP4 Princeton Park Corporate Center, LLC vs. SB Rental I, LLC, et al., No. L-7224-06, Superior Court of New Jersey, Law Division, Middlesex County, unpublished transcript of an oral opinion and order issued March 28, 2007 (supplied to me courtesy of Cheryl Kelly). This still-pending litigation involves a $13,300,000 non-recourse mortgage loan to SB Rental I, LLC, subject to the possibility of springing recourse liability for the full $13,300,000 loan amount being imposed on one or more guarantors (the style of the case includes "et al" and both the style and the District Judge's opinion refer to the plural "defendants") in the event that SB Rental I, LLC placed any subordinate financing on the property. SB Rental I, LLC did place subordinate financing on the property, and in his March 28, 2007 opinion the District Judge held that the loan was therefore fully recourse to the guarantor(s). In addition to a discussion in the District Judge's opinion of whether the springing recourse provision was clear (he held that it was clear), the opinion also included a discussion of whether having the guarantor's(s') liability increase from zero to $13,300,000 due to the borrower's placing a subordinate financing on the property might have prescribed an unenforceable penalty. However, the court did not analyze whether the mortgagee had suffered any actual damages from the subordinate financing (in most states the foreclosure of a superior lien wipes out a subordinate lien), but instead pointed out that the "defendants" -- plural -- "received and retained $13.3 million in loan proceeds" and that the imposition of $13,300,000 liability on the guarantors for the borrower's subordinate financing was "actual damages" because: "In fact, the damages which the plaintiff seeks are equal to the outstanding loan balance and nothing more." The District Judge did not attempt to distinguish between damages caused by the borrower's failure to pay the loan (which was not a springing recourse event) and damages caused by the borrower's subordinate financing.

<u>A Trend in Enforcing Springing Recourse Provisions and the Presumed Rationale for Such Enforcement</u>

During the past several years, other reported cases in addition to the two cases discussed above have enforced springing recourse loan provisions. See, in reverse chronological order: *Blue Hills Office Park LLC v. JP Morgan*, 477 F. Supp. 2d 366 (D. Mass. 2007); *LaSalle v. Mobile*, 367 F. Supp. 2d 1022 (E.D. La. 2004); *Heller Financial v. Lee*, 2002 U.S. Dist. LEXIS 15183 (N.D. Ill. August 12, 2002); and *First Nationwide Bank v. Brookhaven Realty Association*, 637 N.Y.S. 2d 418 (N.Y. App. 1996). See also three excellent recent articles on the subject, all of which are located on readily accessible internet web pages: Kelly, *Real Estate Work-Outs: Running Dry in the Liquidity Crunch?* http://files.ali-aba.org/thumbs/datastorage/skoobesruoc/pdf/TSNR01_chapter_02_thumb.pdf (June 2008); Kuney, *"Springing Guarantee" Fully Enforced in Non-recourse Mortgage Loan: for Borrower's Loan Breaches Including the Failure to Comply with Separateness Covenants*, www.sidley.com/db30/cgi-bin/pubs/Bankruptcy_Update_08.20.07.pdf (August 2007); and Murray, *Carveouts to Nonrecourse Loans: They Mean What They Say!* http://www.firstam.com/content.cfm?id=2920 (2007).

As was the case in the *Six Ventures, Ltd.* opinion, in most of the above-cited court opinions the judge failed to consider the "penalty" issue at all in his opinion. Generally implied, if not always expressed, in the opinions was a rationale similar to the following: (i) the lender made a loan, and a borrower customarily has liability for repaying a lender's loan; (ii) in the particular loan in question the lender made a unique exception, granting the borrower and its guarantor(s) exculpation from the repayment obligation if, but only if, the borrower "kept its end of the bargain" by refraining from the specified springing recourse activities; (iii) since the borrower did not so refrain, the borrower and the guarantor(s) were not entitled to the lender's unique exception, and the customary obligation of repayment returned.

This Author's Analysis and Conclusion[3]

It is the opinion of this author that the business dialogue in most mortgage loan transactions does not follow the rationale that was set out in the immediately preceding paragraph. Instead, the business dialogue generally follows a format such as the following:

> Borrower (before any loan commitment is issued): "The loan is a non-recourse loan, right?"
> Lender: "Yes, that's the deal."
> Borrower (after receiving the lender's loan commitment): "I see the paragraph that says the loan is non-recourse, but it mentions something about your customary carve-out provisions. What are those?"
> Lender: "Don't worry about that; it's just our legal department's standard stuff. Your lawyer can work out the language with our lawyer in the final loan documents."
> Lender's Lawyer to Borrower's Lawyer (during document negotiations): "The commitment says the documents will contain our customary carve-out provisions, and the springing recourse paragraph is standard for us. I don't have the authority to delete it. Just tell your client not to do anything that is prohibited by the paragraph, and there won't be any problem."

While no research has been done other than the author's recollection of his professional experience during the past 38 years to justify the above-quoted scenario, the author believes that a polling of lenders and borrowers about their pre-commitment and contemporaneously-with-commitment verbal dialogue would reveal scenarios very similar to what is quoted above. And, more importantly, the author believes that not a single lender would have answered the borrower's first question in the above scenario with an analysis similar to what was set out in the paragraph of this article that precedes the scenario. Similarly, it is this author's belief that if lenders were polled about why springing recourse provisions are included in their loan documents, not a single one would say that the principal purpose of the springing recourse provisions was to give the lender full-recourse remedies. Instead, they would say that such springing recourse provisions are included to make it prohibitive for the borrower to act improperly -- what some courts and commentators refer to as ***"in terrorem"*** clauses, i.e., clauses whose primary purpose is to place the borrower ***in terror*** against performing the proscribed action. This conclusion is corroborated by occasional references in speech presentations where the speaker uses the term "***in terrorem***" to describe the springing recourse provisions, such as Barton, *Carveouts, Deficiencies, and In Terrorum* [sic] *Clauses*, 2004 Texas Mortgage Lending Institute.

Other than perhaps in the context of will contests, *in terrorem* provisions are not favored by courts. For example, in the case of *Muller v. Light*, 538 S.W.2d 487 (Tex. Civ. App. -- Austin 1976), the court characterized a purported liquidated damages provision in a construction contract to be "an ***in terrorem*** device to insure prompt performance by the builder" and, accordingly, an unenforceable penalty. Similarly, in *Raffel v. Medallion Kitchens of Minnesota, Inc.*, 139 F.3d 1142 (7th Cir. 1998), the court found a purported liquidated damage provision in a lease to be an unenforceable penalty and, in doing so, favorably quoted the following language from a 1915 opinion from the Illinois Supreme Court: ". . . if it [the damage clause in a contract] appears to have been inserted to secure the prompt performance of the agreement, it will be treated as a penalty and no more than actual damages can be recovered." 139 F.3d at 1146. The same court later cited its *Raffel* opinion favorably and described the basis for its decision with essentially the same language in its opinion in *Checkers Eight Limited*

[3] This would be a good time to reemphasize the disclosure and disavowal that is stated in footnote 1 above: (1) the author's clients are predominantly real estate developers and investors, i.e., not mortgage lenders; and (2) the author's comments are solely his personal observations and conclusions, and they in no way represent the views of his law firm or any clients of his law firm.

Partnership v. Hawkins, 241 F.3d 558, 562 (7th Cir. 2001), in holding unenforceable a stipulated fee for failing to make a settlement payment within the prescribed time period. Accord: *In re Dow Corning Corp.*, 419 F.3d 543 (6th Cir. 2005) and *MCA Television Limited v. Public Interest Corporation*, 171 F.3d 1265, 1271 (11th Cir. 1999), which opinions are listed in support of the following statement in 24 WILLISTON ON CONTRACTS, page 249: "Accordingly, a specified sum that is unreasonably large when compared to the damage that could have been anticipated from the breach of the contract, and therefore punishes the breach, is a penalty, as is a sum which is designed to or has the effect of coercing performance of the contract by making the breach so expensive that it forces adherence to the contract."

For a sampling of real estate related court opinions in the author's State of Texas on the issue of penalty versus liquidated damages, see *Flores v. Millennium Interests, Ltd.*, 185 S.W.3d 427 (Texas Supreme Court 2005) (characterizing as an unenforceable penalty a statutory "liquidated damage" provision in connection with a contract for deed); *Stewart v. Basey*, 245 S.W.2d 484 (Texas Supreme Court 1952) (characterizing as an unenforceable penalty a liquidated damage provision in a lease agreement); *Tri-Cities Construction, Inc. v. American National Insurance Company*, 523 S.W.2d 426 (Tex. Civ. App.--Houston [1st Dist.] 1975, no writ), appeal after remand, 551 S.W.2d 106 (Tex. Civ. App.--Houston [1st Dist.] 1977, no writ) (holding a mortgage loan commitment fee to be an unenforceable penalty); *Ashton v. Bennett*, 503 S.W.2d 392 (Tex. Civ. App.--Waco 1973, writ ref'd n.r.e.) (holding an earnest money deposit in a real estate contract of sale to be an unenforceable penalty). See also, among many other sources, the following general analyses on the subject: RESTATEMENT OF THE LAW (SECOND) OF CONTRACTS (1981), pages 157-61, § 356 ("Liquidated Damages and Penalties"); and 24 WILLISTON ON CONTRACTS, pages 248-57, §§ 65:3 and 65:4 ("Distinction between penalties and liquidated damages").

It is the opinion of this author that court opinions referring to the springing full liability as being "actual damages" [Excerpt from the *SB Rental I, LLC* opinion: "In fact, the damages which the plaintiff seeks are equal to the outstanding loan balance and nothing more."] mistakenly confuse the damages caused to the lender by the borrower's failure to repay the loan (which is not a recourse event and, in fact, is generally the basis for the non-recourse exculpatory language) with the damages caused to the lender by the borrower's taking an action that is proscribed in the springing recourse provision. It is also the author's opinion that the judges' opinions in cases such as the two that precipitated this report often reflect an impatience on the part of the judges with the certain specific prior actions or court arguments of the respective defendants. This author predicts a different line of reasoning, i.e., with a thorough analysis of the "penalty" aspect of *in terrorem* clauses, in a future appellate court decision. And this author would especially predict a court's rejection of the springing recourse remedy in the event of litigation involving a guarantor whom the judge does not suspect of having drained the property of cash but instead has merely succumbed to an economic downturn, who has not attempted to delay the lender's foreclosure, and who is now being sued by the lender for the entire loan balance on account of a specified springing recourse action that caused little or no expense to the lender, such as, for example, a prohibited transfer of an insignificantly small, non-controlling limited partner's interest (and for this example, not the interest of the guarantor) or a violation of one of the "single purpose entity" provisions by the borrower's having occasionally used the wrong forms for obtaining materials for the property.

International Guaranties

By Sidney G. Saltz[*]

In this age of globalization, many companies domiciled in other countries have created subsidiaries to do business in the United States. Often, those subsidiaries do not have their own financial statements, and sometimes, even if they have separate financial statements, their net worth is insufficient to assure the other party to a transaction that they have the financial where-with-all to pay and perform in accordance with their undertakings in their agreement. Under those circumstances, the other party may request a guaranty from the foreign parent company.

Guaranties by a foreign company, which I refer to in this Article as "foreign guaranties", present special issues of which the drafter would be well advised to be aware. In the typical domestic guaranty, an action under the guaranty may be brought in the domicile of the guarantor, and sometimes in the place of residence of the party benefiting from the guaranty. It is a matter of reviewing the jurisdictional and venue provisions in the applicable state, and determining the rules for service of process. In any case, the action is brought in the United States and any judgment is entitled to full faith and credit in other states in which assets of the guarantor may be located. That may not be the case with international guaranties.

There are four basic problems with international guaranties which should be dealt with in the body of the guaranty itself. The first relates to consent to jurisdiction, the second to service of process, the third to choice of law. The final major issue, and perhaps the most important, is the issue of enforcing any judgment obtained in a United States court in the home country of the guarantor.

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Let us assume, for the sake of this article, that the guaranty relates to a lease for premises in Chicago, Illinois, the landlord being an Illinois limited liability company having its principal place of business in Cook County, Illinois, the county where Chicago is located, and the guarantor being a German company. In a diversity action in the Federal District Court for the Northern District of Illinois, the action may be brought where all the plaintiffs or all of the defendants reside. Although the Federal statutes provides for that jurisdiction, and although it is established law that parties cannot, by agreement, confer jurisdiction (as opposed to venue) where it does not otherwise exist, it is helpful to have language in the guaranty agreeing to jurisdiction (as well as venue) if the international company can be properly served with process. Hence the guaranty may contain the following language regarding jurisdiction:

> With respect to any dispute or legal action of any kind arising from the terms of this Guaranty that any party may have, either during the term of this Guaranty or thereafter, it is expressly agreed that such action shall be brought either in the Circuit Court of the State of Illinois in the County of Cook (or in the Federal District Court for the Northern District of Illinois, to the extent such court has jurisdiction thereof), and that such court shall be deemed to be the court of sole and exclusive jurisdiction and venue for the bringing of such action. The foregoing consent to jurisdiction and venue shall not constitute general consent by Guarantor to jurisdiction and venue in the State of Illinois for any purpose except as provided herein and shall not be deemed to confer rights on any other person or entity.

The final sentence affords the guarantor protection against other actions in the chosen jurisdiction by providing, in effect, that the consent to jurisdiction and venue (and service of process) is limited to this guaranty.

The second issue relates to the service of process. Since the process of the Circuit Court of Cook County or the Federal District Court for the Northern District of Illinois does not extend to Germany, provision has to be made for the appointment of someone in the State of Illinois to accept service of process so that the case may be commenced. That can also be dealt with in the guaranty, designating each of the tenant and the Secretary of State of the state where the contract is to be performed as the agent for the guarantor to accept service of process. In our example, the following language may be suitable for that purpose:

> Guarantor agrees that (a) Tenant and (b) the Secretary of the State of Illinois, shall each hereafter have full authority and be duly empowered to accept service of process on behalf of Guarantor in connection with the enforcement of this Guaranty, and Guarantor hereby appoints Tenant and such Secretary of State as its agents for purposes of acceptance of service of process in connection with the enforcement of this Guaranty, so long as a copy of any such legal proceeding served upon Guarantor through Tenant or the Illinois Secretary of State is promptly furnished to Guarantor by an international courier service at the following address: ____.

Note that the language provides for a copy of the complaint to be sent to the defendant in its home jurisdiction.

The choice of law language is fairly typical:

> It is expressly understood and agreed by Guarantor and Landlord that all matters arising out of this Guaranty, including the validity or any provisions hereof, are to be governed by, interpreted and construed in accordance with the laws of the State of Illinois (without giving regard or effect to any conflicts of law rules or other choice of law rules).

Of course, in each instance, references in the quoted language to Illinois and Cook County are merely illustrative and the appropriate state and county (if appropriate) should be inserted if the reader is using the examples.

The final issue, enforceability of the judgment in the home country of the guarantor, is more problematic. It is unlikely that the drafter of the guaranty knows the law of that country sufficiently to advise the client that if it obtains a judgment against the guarantor in the courts of the United States, it will be able to enforce that judgment in the foreign country without having to bring a totally new action and prove its case again—an expensive and time consuming outcome. Some countries may have laws providing for the enforceability of foreign judgments, provided that they are not obtained in a manner contrary to the public policy of that country.

A way to have some level of comfort with that issue is to require that the guarantor provide an opinion from its attorney in the country where the judgment is proposed to be enforced, stating that it will be enforceable without a new trial on the law and facts. The results disclosed by those opinions can be quite surprising. Some years ago, I represented a landlord who requested a guaranty from a German company. Fortunately we did request such an opinion and were shocked to learn that the taking of pre-trial discovery was against public policy in Germany. Accordingly, if our client had done discovery in connection with its action against the guarantor—a very typical trial preparation tool, it could not have enforced the judgment. I do not know whether the opinion was accurate and I do not know if that continues to be the law in Germany today, but if an action under that guaranty had been required, my client would certainly have not done pre-trial discovery without further investigation of German law.

If the foreign guarantor is unwilling or unable to provide such an opinion, it may be incumbent on the party seeking the guaranty to hire its own attorney in the guarantor's home country, or to seek advice from an American firm with attorneys licensed to practice in that country. Retrying the issues in a foreign country may be very difficult and expensive, and may require the trial to be conducted in a hostile, or at least unfriendly, forum.

Conclusion

If a party to a transaction involving the United States subsidiary of a company domiciled in a foreign country deems it necessary to obtain the guaranty of the parent company to conclude the deal, it is incumbent on that party to seek to assure that the guaranty has real value. That assurance can be accomplished by inserting provisions in the guaranty not usually required in guaranties from United States companies, and also assurances that, under the law of the foreign country, a judgment obtained in the United States court will have the anticipated value when collection on the judgment is sought in that country. After all, a guaranty, even from a very strong company, is no good if the guarantor cannot easily be sued, and a judgment is no good unless it is feasible to collect it.

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ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

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Trusts, Estate Planning And The Family Jet

When a high-net worth family or individual is purchasing a jet that will be flown primarily for personal and family use, it can be useful to consider at the outset how the structure of the ownership and operation of the aircraft fits within the estate plan of the owner and any future ownership or usage by his or her heirs.

Early planning may help avoid the need for future transfers of ownership of the aircraft. Most States impose taxes on transfers of aircraft, and there may also be other state and federal tax issues involved. These often arise when trying to restructure the ownership of the aircraft and transfer it to a trust in order to satisfy estate planning needs.

Despite the many limitations on aircraft ownership and operations contained in the Federal Aviation Regulations, the US Federal Aviation Administration (FAA) does allow registration of an aircraft in the name of a Trustee of a trust. The FAA has requirements for Trustee's of trusts which own aircraft. Under FAR 47.7(c), each Trustee of the trust must be either a U.S. citizen or a resident alien. They must also submit an Affidavit of Citizenship from each Trustee and a copy of the Trust Agreement to the FAA. The Federal Aviation Regulations (FARs) also require that they submit a “copy of each document legally affecting a relationship under the trust.”

There are special requirements which must be met if any beneficiary is not either a U.S. citizen or a resident alien. An Affidavit is required from each Trustee stating that “the trustee is not aware of any reason, situation, or relationship (involving beneficiaries or other persons who are not U.S. citizens or resident aliens) as a result of which those persons together would have more than 25 percent of the aggregate power to influence or limit the exercise of the trustee's authority.”

If persons who are neither U.S. citizens nor resident aliens have the power to direct or remove a Trustee, either directly or indirectly through the control of another person, the Trust Agreement must provide that those persons together may not have more than 25 percent of the aggregate power to direct or remove a Trustee. However, the regulation does not prevent those persons from having more than 25 percent of the beneficial interest in the trust.

Trusts, frequently called “owner trusts” are commonly utilized to own and register an aircraft in the United States. If an existing trust or a trust organized for a different purpose is later utilized to own the aircraft, the Trust Agreement may need to be amended in order to satisfy the FAA requirements mentioned above. The FAA must approve all Trust Agreements used to register an aircraft. As such, confidentiality of the terms regarding other assets held in a trust which has multiple purposes can be a concern if an aircraft is added to an existing trust.

Addressing aviation issues in the trust created to meet other estate planning and family needs can quickly become complex. Deciding how to best handle each issue varies from person to person. Consulting an attorney experienced in corporate jet registration and operations can assist by providing guidance on how to ensure FAA compliance while satisfying estate planning goals.

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WHERE THERE'S A WILL, THERE'S A . . . DUTY?:

A CLOSER LOOK AT THE SAFEKEEPING OF CLIENTS' ORIGINAL ESTATE PLANNING DOCUMENTS

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Before the ink has dried on their newly executed wills, clients often ask their attorneys and other advisors where they should store their original estate planning documents. A number of options are available, each with their own advantages and disadvantages. The options for storing original estate planning documents include in the client's home safe, in the client's safety deposit box at a bank, with the drafting lawyer, with the named fiduciary, with a trusted family member, friend, or advisor, or in some jurisdictions with respect to wills, with the clerk or registrar of the appropriate court. This article examines the duties of a lawyer who retains a client's original estate planning documents for safekeeping. The article also considers safekeeping by a bank, trust company, or other financial institution serving as a fiduciary under a will or trust, or as an advisor to the client.

Introduction

The law governing the retention of original estate planning documents varies from state to state. Some states have affirmative laws imposing certain duties on persons in possession of original wills. In other states, the state bar associations have issued ethics opinions on the retention of original estate planning documents. Yet many states provide little or no guidance on the issue. The following discussion draws upon various state laws, legal ethics opinions, and legal treatises. The safekeeping lawyer should become familiar with the laws in the lawyer's state in working to establish "best

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practice” policies. Likewise, a bank, trust company, or other financial institution serving as the custodian of original estate planning documents should considering adopting policies akin to those rules applicable to lawyers in their respective states.

I. The General Rule

Generally speaking, the safekeeping of a client’s will does not create any additional duties for the drafting lawyer, such as exercising vigilance to learn of the client’s death or otherwise causing the will to be submitted for probate. See Scholen v. Guaranty Trust Co. of New York, 288 N.Y. 249, 43 N.E.2d 28 (1942) (leading case); see also 79 Am. Jur. 2d Wills § 734; Annotation, Duty and Obligation Assumed by Trust Company or Other Person to Which Will is Delivered for Safekeeping, 141 A.L.R. 1277. Additionally, the ACTEC Commentaries to Model Rule of Professional Conduct 1.8 state that the mere retention of a client’s original estate planning documents does not make the client an “active” client or impose any obligation on the lawyer to inform the client of tax law developments or to learn of any changes with respect to the client’s family status or financial situation.

However, at least one court has indicated its willingness to impose additional legal obligations under contract theory where a lawyer makes certain representations to the client. For example, if a lawyer states to the client that he will monitor the obituaries for news of the client’s death (or states that he has the means for such monitoring) or promises to otherwise cause the client’s will to be probated after the client’s death, the court stated that it would be appropriate to hold the lawyer to his end of the bargain. See, e.g., Scholen, 288 N.Y. 249, 43 N.E.2d 28.

Perhaps taking a cue from the Scholen court, the New York Bar Association has opined that whether a lawyer has additional obligations with respect to the safekeeping of a will is a matter of contract law. See N.Y. Ethics Op. 724 (1999). The contractual duty may be express or implied, creating a heightened need for the safekeeping lawyer to define clearly the custodial relationship. However, absent an express or implied agreement, the lawyer has no positive duty to learn of a client's death or to take other steps following the client's death. Id.; see also Mass. Ethics Op. 76-7 (1976).

II. The Common Exception: Notice of a Client's Death

A. State Law and the Uniform Probate Code

A number of states impose a positive duty on the custodian of a will upon receiving notice of the testator's death. Under these statutes, the custodian of a will must deliver the will to the executor named in the will or to the court having jurisdiction over the administration of the estate. See, e.g., Conn. Gen. Stat. § 45a-282; Md. Code, Est. & Trusts § 4-202; Okla. Stat. tit. 58, § 21; Wash. Rev. Code § 11.20.010; see also 79 Am. Jur. 2d Wills § 730. The Uniform Probate Code also requires any person having custody of a will to deliver the will to a person able to secure its probate (usually the executor) after the death of the testator. See Uniform Probate Code § 2-516.

The legislative intent behind these state statutes and the Uniform Probate Code is to encourage the probate of wills and to prevent persons from benefiting by refusing to probate an unfavorable will in their possession. The state statutes and the Uniform Probate Code refer simply to the "person having custody" of the will and do not distinguish between the lawyer as safekeeper for his client and other persons who may be in possession of a will. Thus, a corporate fiduciary in possession of an original will is under a legal obligation to produce the will to the appropriate court. Most states with such laws, however, only impose the duty upon actual notice to the will's possessor at the testator's death.

B. State Bar Ethics Opinions

Several state bar associations have issued ethics opinions addressing a safekeeping lawyer's duty upon notice of a client's death, and generally take one of two approaches. New York, for example, treats the safekeeping lawyer as having an ethical obligation to carry out the client's wishes. As discussed above, this obligation appears grounded in contract law and is based on the implied understanding between lawyer and client. In most cases, the New York Bar Association believes that there is an implied understanding between the safekeeping lawyer and his client that upon notice of the client's death, the lawyer will take steps to see that the will is given effect by notifying the executor named therein of the will's existence. See N.Y. Ethics Op. 521 (1980). The New York Bar Association further states that a lawyer may notify either the executor named in the will or the beneficiaries under the will, and that such notification does not violate the duty of confidentiality between lawyer and client. Rather, the client is deemed to have provided implicit authorization for such disclosure. See id.; N.Y. Ethics Op. 724.

Pennsylvania takes a different approach. The Pennsylvania Bar Association has opined that the safekeeping lawyer has an "absolute obligation" to take steps to cause a will to be probated upon notice of a client's death. See Pa. Ethics Op. 97-66 (1997). Pennsylvania views the safekeeping lawyer as an "officer of the legal system and a public citizen having special responsibility for the quality of justice." Id. Not causing a will to be submitted to probate is synonymous with conduct prejudicial to the administration of justice. Id. The seemingly strong language of this ethics opinion may be tempered somewhat by the particular facts presented to the state's ethics committee. In that matter, the executor refused to probate an unfavorable will known to be in the lawyer's possession in order to benefit himself. Whether Pennsylvania would impose the same ethical duty where no self-dealing was present remains unclear.

III. Best Practices for the Safekeeping of Original Estate Planning Documents

A. General Considerations

The American Bar Association has long maintained that it is permissible for a lawyer to act as the custodian of a client's original will. See ABA Informal Op. 981 (1967). However, some states have cautioned against the safekeeping of original documents absent a client's affirmative request because the lawyer may be perceived as impermissibly soliciting business. These states caution that the retention of original documents may exert pressure on clients to retain the same lawyer for future matters or on executors named within the documents to retain the lawyer with respect to estate administration matters. See, e.g., State v. Gulbankian, 54 Wis.2d 605, 196 N.W.2d 733 (1972); Tex. Ethics Op. 280 (1964). In most states, however, an informative discussion between the drafting lawyer and client regarding the lawyer's possible role as custodian does not raise an ethical concern so long as the lawyer does not exert influence over the client or the client's wishes. See, e.g., N.Y. Ethics Op. 521; Pa. Ethics Op. 01-300 (2001).

Because of these concerns and others, the client may wish to ask another party to retain his original estate planning documents. For example, a bank, trust company, or other financial institution can provide a secure place to safekeep original documents against loss or destruction. Moreover, the corporate institution will have ready access to the documents if its services are needed as a fiduciary under the will or trust.

B. Best Practices

Regardless of whether the drafting lawyer, a corporate institution, or another person retains the original estate planning documents, the safekeeper should adopt "best practices." These best practices, as enumerated by a multitude of sources including the ACTEC Commentaries, include the following:

- Provide written receipt to the client indicating the safekeeping of the document. The written receipt should:
  - Identify which documents are being stored;
  - State that the safeguarding of the documents is per the client's request;
  - Request that the client notify the safekeeper of any change in address; and
  - If a lawyer is serving as safekeeper, indicate that the fiduciary named in the documents is not required to retain the lawyer for assistance in administering the estate or providing other legal services.
- Provide a copy of the original documents to the client. The copy should be marked clearly as "copy" and indicate where the original documents are being stored.
- Advise the client that the client has the right to request and promptly receive the documents at any time.

- Define the nature of the custodial relationship (*i.e.*, no obligation of the safekeeping lawyer to review the client's estate plan; no obligation of the safekeeping lawyer or corporate fiduciary to learn of the client's death), including any steps the client should take. For example, the safekeeper might advise the client to inform close family members or friends of the location of the original documents.
- Retain documents in accordance with Model Rule of Professional Conduct 1.15:
  - Properly identify the documents;
  - Appropriately safeguard the documents in a safe, vault, safe deposit box, or other secure place where they will be reasonably protected against loss or destruction; and
  - Comply with the client's written direction regarding disposition of the documents.

A safekeeping lawyer or financial institution should consider clarifying the nature and extent of its custodial role with the client. Particularly when operating in a contract regime such as New York, the lawyer or financial institution should proactively avoid the creation of an inadvertent implied obligation. Although this conversation may be awkward or perhaps offensive to some clients, such discussion allows the client to make an informed decision regarding the safekeeping of estate planning documents and provides an opportunity to inform the client as to additional steps the client should take, such as telling others where to locate the original documents. See Pa. Ethics Op. 01-300.

IV. Terminating the Custodial Relationship

Once a custodial relationship has been established, the safekeeping lawyer may question when and under what circumstances it is appropriate to dispose of original estate planning documents. Numerous state ethics opinions require a lawyer to retain and ensure the safekeeping of original estate planning documents *indefinitely*, absent a controlled return of the documents to the client or compliance with state law. See, e.g., Conn. Ethics Op. 98-23 (1998) (distinguishing between ordinary client files and original estate planning documents); N.Y.C. Ethics Op. 1999-5 (1999); Or. Ethics Op. 1991-60 (1991); Pa. Ethics Op. 01-300; Utah Ethics Op. 132 (1993).

Several state statutes and ethics opinions address how a lawyer may terminate the custodial relationship. For example, a lawyer who is retiring or whose firm is dissolving may notify the client and request instructions for the disposition of the original will. See N.Y.C. Ethics Op. 1999-5. If the lawyer is able to reach the client and the client requests the return of the original document, the lawyer must take adequate steps to verify that it reaches the client safely. See, e.g., Mass. Ethics Op. 76-7 (1976). In attempting to reach the client, the safekeeping lawyer must be vigilant to avoid revealing the contents of or the existence of a client's will to anyone outside the attorney-client relationship. See Va. Ethics Op. 378 (1980). Thus, the ability to properly notify a client and terminate the custodial relationship rests on two assumptions: (1) the safekeeping lawyer has current contact information for the client and (2) the safekeeping lawyer is confident that his communications will reach the client and only the client.

Perhaps in recognition of the difficulties of terminating the custodial relationship, several states have enacted statutes governing how and when a lawyer may terminate a custodial relationship. California enacted one of the more protective statutes in 2007. See Cal. Prob. Code §§ 700 *et seq*.; see also Cal. Ethics Op. 2007-173 (2007). California's Probate Code provides that a lawyer may generally terminate a deposit by: (1) personal delivery of the document to the client; (2) mailing the document to the client's last known address, by registered or certified mail with return receipt requested, and receiving a signed receipt; or (3) a method agreed on by the client and lawyer. See Cal. Prob. Code § 731.

In the case of a client's death, a California lawyer may terminate the deposit by personal delivery of the document to the client's personal representative (or by personal delivery of the document to the client's trustee if the document is a trust). Id. § 734(a), (c). If the lawyer does not have actual notice that a personal representative has been appointed for the client, the lawyer must (1) deliver the will to the Clerk of the Superior Court of the county in which the estate of the decedent may be administered and (2) mail a copy of the will to the person named in the will as the personal representative, if the person's whereabouts is known to the lawyer, or if not, to a person named in the will as a beneficiary, if the person's whereabouts is known to the lawyer. Id. §§ 734(b); 8200.

The California statute further provides that where a safekeeping lawyer has not received notice of a client's death, the lawyer may transfer original estate planning documents to another lawyer. In such an event, the transferring lawyer must first mail notice to reclaim the document to the client's last known address and wait 90 days for the client's response. Id. § 732(a). Additionally, if a lawyer is deceased, lacks legal capacity, or is no longer an active member of the State Bar, a deposit may be terminated by transferring the original document to the Clerk of the Superior Court of the county of the client's last known residence. Id. §§ 732(c); 735. In the event of a transfer to another lawyer or to the Court, the transferring lawyer (or the person transferring documents on behalf of the lawyer) must provide notice to the State Bar of California. See id. § 733. Despite these protective features for the safekeeping lawyer, California's statute does not apply to other safekeepers, such as banks, trust companies, or other financial institutions.

By comparison, Indiana's statute enacted in 2006 applies to any person in possession of an original will. See Ind. Code § 29-1-7-3.1; see also David A. Smith, "Filing Wills with the Circuit Court Clerk, Res Gestae (June 2006). The Indiana statute generally permits a person to deposit a will with the Clerk of the Circuit Court of the county in which the testator resided when the will was executed. The Indiana statute applies whether or not the testator is still living and permits any person, not just a safekeeping lawyer, to deposit the will with the Circuit Court. See Ind. Code § 29-1-7-3.1. Upon deposit, the will is placed in a sealed envelope and is deliverable only to the testator or to persons authorized by the testator in a signed writing. Id.

However, the Indiana statute only applies to wills, not other estate planning documents such as trusts, advance medical directives, or powers of attorney, and is of limited value. Further, the Circuit Court may collect a fee upon deposit. Notably, the Clerk must retain the will for 100 years after the date of deposit if no notice of death is received. If notice of death is received, the Clerk may deliver the will to the appropriate court having jurisdiction over the administration of the decedent's estate. Id.

Most states do not afford lawyers the luxury of a statutory regime like California's and Indiana's probate codes. Absent such a statute, upon retirement or dissolution, the safekeeping lawyer should index the original estate planning documents of missing clients and place them in storage or turn them over to a successor lawyer who is assuming control of the lawyer's firm or active files. See Assoc. of Bar of City of New York, 55 The Record 42 (2000); ABA Formal Opinion 92-369 (1992). Again, the safekeeping lawyer must proceed cautiously to preserve the confidences and secrets of the testator client.

Conclusion

In light of the duties discussed above, a drafting lawyer should carefully consider the custodial services of original estate planning documents offered to clients. The lawyer may wish to discuss the nature and extent of this service with clients and provide for a method of terminating the custodial relationship. As law firm vaults continue to be filled with original estate planning documents, it is likely that other states will enact protective statutes addressing when and under what circumstances a safekeeping lawyer may dispose of original estate planning documents. In any event, the safekeeping lawyer should become familiar with the affirmative laws in his or her state and the legal ethics opinions governing document retention. Because the statutes and ethics opinions discussed deal with lawyers and not financial institutions, these institutions should consider adopting "best practice" policies akin to the rules applicable to lawyers in their respective states, as their conduct is likely to be measured by the rules applicable to the safekeeping lawyer.

Charitable Strategies for Trust Beneficiaries

This *Trust Topics* presents the benefits of making distributions of appreciated property for philanthropically-minded beneficiaries.

Certain trusts permit distributions to be made to trust beneficiaries at the discretion of the trustee. There are benefits to making these distributions in the form of appreciated property—also called a distribution in kind**.** A distribution in kind is a distribution of property (for example, shares of stock), rather than cash, from a trust. The technique of distributing appreciated property bears investigating for the potential advantages to trust beneficiaries and charitable organizations that receive gifts from trust distributions.

When a trustee distributes appreciated property to a beneficiary, the trustee can determine the capital gains treatment of the distribution. The trustee does this in accordance with an election granted under Section 643(e)(3) of the Internal Revenue Code, commonly referred to as the 643(e) election.

Trustee may elect to recognize a capital gain

A trustee may elect to treat a distribution in kind as if the distributed property had been sold to the beneficiary at its fair market value on the distribution date. If that election is made, a capital gain is generated equal to the difference between the adjusted cost basis of the property and the fair market value of the property. (Adjusted cost basis is the original value of an asset adjusted for, among other things, mergers, stock splits and reinvested dividends.) That capital gain is taxable at the trust level. The beneficiary's cost basis in the property will be the fair market value of the property distributed. Such an election would not typically be made unless the trust had offsetting losses.

Trustee may decide not to recognize a capital gain

If a trustee distributes appreciated property and does not elect to recognize a capital gain, no gain is recognized by the trust. The beneficiary's cost basis in the property remains the adjusted cost basis of the trustee (not the fair market value). The beneficiary would, therefore, realize a capital gain upon the sale of the assets.

If, instead of selling the property and recognizing a capital gain, the beneficiary contributes the appreciated property to charity, everyone may benefit. Scenarios One and Two outline this strategy.

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Scenario one: When the trustee has the discretion to distribute both income and principal

Consider a trust in which the trustee has the discretion to pay income and principal to the beneficiary. Assume the trust has received dividend and interest income of $50,000 for the year. The trustee decides to distribute securities from the principal of the trust (a distribution in kind) and not the dividend and interest income.

For example, assume the trustee chooses to distribute ABC stock purchased in 1970 that now has a fair market value of $50,000 and an adjusted cost basis of $10,000. The stock distribution is made to a trust beneficiary.

The trustee in this scenario does not elect to recognize a capital gain, which means that the trustee's adjusted cost basis is passed on to the beneficiary. In other words, no gain is recognized on the distribution to the beneficiary; it is capital gains tax neutral.

The beneficiary, in turn, chooses to contribute the distributed property to a charitable organization.

Scenario one: Win-win tax result

- The amount of ordinary income the beneficiary has to report is limited to $10,000. That is, the ordinary income reportable by the beneficiary is only the value of the adjusted cost basis of the securities, not the $50,000 fair market value of the securities;

- Further, the beneficiary is able to claim a charitable income tax deduction of $50,000 when the charitable gift is made (subject to certain limitations based on the beneficiary's overall income); and

- No capital gain is recognized by either the beneficiary or the trust. In addition, the charitable organization can sell the securities at any time without incurring capital gains taxes. Thus, no capital gains taxes need to be paid by any of the three parties: trust, beneficiary or charity.

As is the case with individuals, trusts are responsible for paying taxes on dividend and interest income earned during the year. However, to the extent a distribution is made to a trust beneficiary, the trust is entitled to a distribution deduction to offset income.

In this scenario, the trust is entitled to a deduction equal to the value of the adjusted cost basis of the securities distributed. Thus, the trust would potentially be liable for taxes on only $40,000 of dividend and interest income (the $50,000

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of dividend and interest income earned by the trust, less the $10,000 distribution deduction).

The trust must still pay taxes on $40,000 of income earned for the year, but the trustee has the benefit of being able to reinvest the net income after taxes in any manner the trustee likes. If all the income was distributed to the beneficiaries, the trustee might be forced to sell some existing trust holdings to raise the cash to make a new investment. And that sale might have capital gains tax consequences of its own.

The trustee has, in effect, diversified a low basis stock position without incurring any capital gains taxes. In accordance with the Prudent Investor Rule, which is the law governing the investment of trust assets in most states, a trustee must diversify trust assets, unless the trustee determines that it is in the interest of the beneficiary not to diversify. Accordingly, for trusts with a large block of low-basis stock, the strategy bears consideration as part of a tax-efficient diversification program.

In addition, the beneficiary has made a contribution of appreciated securities to a charitable organization without generating any capital gains for a charitable deduction equal to the *fair market value* of the securities.

Scenario two: When the trustee is required to distribute income and has the discretion to distribute principal

Consider use of this strategy for a trust that requires all of its income to be paid to the beneficiary, and the trustee, in the trustee's discretion, can make principal payments to the beneficiary.

Assume the trust has dividend and interest income of $50,000 for the year, and the trustee is required to distribute that $50,000 to the beneficiary. In addition, as a principal distribution, the trustee chooses to distribute securities with a fair market value of $50,000 and an adjusted cost basis of $10,000 to the beneficiary. The trustee does not elect to recognize a capital gain. The beneficiary contributes the distributed property to a charitable organization.

Scenario two: Win-win tax result

- The amount of ordinary income the beneficiary has to report is limited to $50,000 (the amount of the dividend and interest income distributed). The distribution of the securities with a fair market value of $50,000 is in effect a tax-free distribution of principal (assuming any capital gains taxes payable as a result of the sale of other trust assets during the course of the year are paid by the trust);

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- Further, the beneficiary can claim a charitable income tax deduction of $50,000 when the charitable gift is made (subject to certain limitations based on the beneficiary's overall income); and

- No capital gain is recognized by either the beneficiary or the trust, and the charity can sell the securities without the imposition of capital gains taxes. Again, no capital gains taxes need to be paid by any of the three parties: trust, beneficiary or charity.

From the trustee's standpoint, since the trust is required to distribute all of its income, no income tax is payable by the trust on that income, and no capital gain is recognized on the principal distribution.

Trustee's discretion is key

For philanthropically-minded trust beneficiaries, the benefits of distributing appreciated property in kind for all involved can be very attractive. However, for the strategy to work in either scenario, a distribution in kind must be made at the trustee's *discretion* from either income or principal. A distribution in kind would not result in the same benefits if, for example, the distribution to the beneficiary is made in satisfaction of an obligation to distribute a fixed amount. In that case, a capital gain will be recognized at the trust level, and a capital gains tax will be payable by the trustee. The trustee would not be able to distribute low-basis securities to the beneficiary without capital gains tax consequences.

If the trustee has discretion, the technique of distributing appreciated property in kind is well worth exploring.

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NEW VOLUNTARY DISCLOSURE PROCEDURE FOR OFFSHORE ACCOUNTS

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Amidst the UBS investigation of offshore bank accounts, the Internal Revenue Service announced, in a memo dated March 23, a new guideline to encourage US taxpayers to come clean on their offshore accounts without the risk of criminal prosecution and significantly increased penalties.

Although there has been a voluntary compliance program in place for many years on an informal basis, many taxpayers have been reluctant to come forward for fear that the penalties can exceed the amounts in the offshore accounts. The new program sets forth maximum civil penalties and an agreement not to criminally prosecute. It is to be administered centrally in the Philadelphia service center to ensure uniformity in the assessment of tax and penalties. Taxpayers who wish to avail themselves of this offer must come forward prior to September 23, 2009. Commissioner Shulman said that "[F]or taxpayers who continue to hide their head in the sand, the situation will only become more dire", including potential criminal prosecution.

Taxpayers may avail themselves of the reduced penalties provided they are not yet subjects of a criminal investigation and cooperate fully with the IRS. It is not clear to what extent such cooperation will be a prerequisite to accepting the reduced penalties. This writer believes that all details regarding the source of the funds, how the taxpayer opened the account and whether there were other professionals involved in the establishment of the account or any company or trust formations will be required to be disclosed.

Voluntary disclosure requests will be resolved under the following framework::

1. The taxpayer must file amended returns including Form TDF 90-22.1 (Foreign Bank Account Return (FBAR)) and informational returns (i.e. Form 3520 or 5471) for the preceding six years (unless the account(s) were opened less than six years ago, then for such number of years they existed)
2. The payment of tax and interest for the six years plus a payment of the accuracy related penalty of 20% or a 25% penalty for failure to timely file. Reasonable cause will not be accepted as a defense to such penalties.
3. The payment of a 20% penalty on the highest balance in the offshore account during such six year period. This penalty may be reduced to 5% if the taxpayer did not open or create the foreign account (e.g., it was inherited), has never withdrawn funds from the account or added funds thereto and all US taxes were previously paid on the funds deposited in the account.

A taxpayer who wishes to come clean will proceed through the Criminal Investigation Division which will then process the returns in accordance with the IRM Section 9.5.11.9.(http://www.irs.gov/irm/part9/ch05s13.html) If the taxpayer meets all the requirements, the returns will then be forwarded to the Philadelphia Offshore Identification Unit (POIU) for examination, which will then issue a closing letter.

Prior to this announcement, taxpayers had the option of making a formal voluntary compliance offer through the CID (often referred to as a “noisy filing”) or simply filing the amended returns in the mail (a “stealth filing”). The unknown factor up until now in either case has been how the FBAR penalties will be assessed. These penalties were recently increased to the greater of $100,000 or 50% of the highest balance in the account for each year of nonfiling. The current initiative will resolve this uncertainty in favor of a one time 20% penalty. Taxpayers who file under this initiative will also avoid numerous other potential penalties and possible criminal prosecution. It is this author’s view that taxpayers with unreported offshore income should RUN, not walk, to their tax attorney and seek to resolve their delinquency prior to the six month deadline.

Further information can be found at:
http://www.irs.gov/newsroom/article/0,,id=206012,00.html

Recent Valuation Case Summaries

By John H. Hardwick, Jr., Esq.
Management Planning, Inc.

<u>Litchfield v. IRS</u>, T.C. Memo. 2009-21. Filed January 29, 2009.

The decedent was a minority shareholder in two family holding companies formed in the 1920s, one (LRC) with Iowa farmland and marketable securities and the other (LSC) with marketable securities. Both companies were incorporated as C corps and had unrealized capital gains tax liability on the potential sale of substantially appreciated assets.

Valuation experts for the estate and IRS deducted discounts for built-in capital gains taxes, lack of control (minority interest) and lack of marketability, as follows:

	LRC		**LSC**	
	Estate	*IRS*	*Estate*	*IRS*
Capital Gains Taxes	17.4%	2.0%	23.6%	8.0%
Lack of Control	14.8%	10.0%	11.9%	5.0%
Lack of Marketability	36.0%	18.0%	29.7%	10.0%

The Court agreed with the estate on capital gains taxes and lack of control but reduced its lack of marketability discounts to 25% (LRC) and 20% (LSC).

There are a few factors considered in Judge Swift's opinion that deserve mention:

✓Unlike recent Circuit Court decisions in *Dunn* and *Jelke*, there was no assumption of immediate liquidation of underlying assets on the valuation date in calculating potential capital gains taxes. The estate's expert considered the history of asset sales and plans for future sales and then projected holding periods and sale dates, estimated future appreciation, calculated taxes and, finally, reduced the taxes to present value. The IRS expert failed to consider future appreciation in determining present value.

✓Both experts used public guidelines (closed-end funds for marketable securities and REITs and RELPs for farmland) to support their discounts for lack of control. However, the IRS expert's discount for LRC was improperly weighted so as not to reflect the fact that farmland represented two-thirds of net asset value.

✓Relative "investor rights" in LRC and LSC were measured by the estate's expert as part of his discount for lack of control analysis. For example, the inability of a minority investor to do much about LRC's low historical returns (only 1% for farmland) helped support a larger discount for LRC than for LSC.

✓The Court's explanation for reducing the discounts for lack of marketability was brief. It said the discounts were "too high" when combined with discounts for lack of control. It also noted that the estate's expert had used a lower discount in a previous gift tax return and had relied upon "outdated data" for restricted stock discounts.

COMMENT: In the context of the lack of marketability of an interest in a closely held family business, older restricted stock studies reflecting longer Rule 144 holding periods are actually more relevant than more recent studies with shorter holding periods.

<u>Gross v. Commissioner</u>, T.C. Memo. 2008-221. Filed September 29, 2008.

After discussions and agreement with her two daughters about the need for a family limited partnership for investment management purposes, Bianca Gross filed a certificate of limited partnership with the State of New York on July 15, 1998. Transfers of marketable securities and nominal cash to a partnership account over the next few months were completed by December 4, 1998. On December 15, 1998 Ms. Gross and her daughters signed the partnership agreement and Ms. Gross made 22.25% gifts of limited partnership interests to each daughter. A 35% combined valuation discount was applied in valuing the gifts.

The IRS argued that indirect gifts of marketable securities had been made because the partnership was not formed until the agreement was signed, which was after the transfers.

Judge Halpern ruled in favor of Ms. Gross. The filing of a certificate of limited partnership is conclusive evidence of the formation of the partnership under New York law. Furthermore, New York law permits formation of a general partnership where limited partnership formation requirements fail if the conduct of the parties suggests a partnership arrangement. The Judge reviewed the facts and found nothing inconsistent with a limited or general partnership's formation on July 15.

COMMENT: MPI was valuation expert for Ms. Gross. Our combined discount was approximately 41%. A combined discount of 35% was stipulated by the IRS and Ms. Gross.

<u>Holman v. Commissioner</u>, 130 T.C. No. 12. Filed May 28, 2008.

In a reviewed opinion in a case involving gifts of limited partnership interests within a few days after the partnership was formed and funded, the Tax Court rejected IRS "indirect gift" and "step transaction" arguments but said transfer restrictions in the partnership agreement should be ignored for valuation purposes, relying on Code Section 2703. In doing so, we believe the Court did not follow hypothetical willing buyer-willing seller standard precedent (see *Morrissey* and *Simplot* cases) when it speculated that a partner who wanted out would be accommodated. We understand many in the legal community view this as reversible error. In fact, the taxpayer has appealed.

MPI was the taxpayer's valuation expert. Our combined valuation discount of 44% (14% minority interest and 35% lack of marketability) for the 1999 gifts was reduced to 22% (11% and 12.5%).

Under Section 2703 a restriction on transfer is disregarded unless (1) it is a bona fide business arrangement, (2) it is not a device to transfer property to the family for less than adequate consideration and (3) its terms are comparable to similar arrangements between persons in an arm's length transaction. The Court did not rule on the third requirement because it decided the transfer restrictions in the partnership agreement failed to meet the first two. It saw no "bona fide business purpose" where the primary reason for the partnership was preservation of family wealth. As for the second requirement's "device" test, the Court stated:

> "….given the significant minority interest and marketability discounts from an LP unit's proportional share of the partnership's NAV that each expert would apply in valuing the gifts, it would appear to be in the economic interest of both any limited partner not under the economic necessity to do so but wishing to make an impermissible assignment of LP units and the remaining partners to strike a deal at some price between the discounted value of the unit and the dollar value of the units' proportional share of the partnership's NAV. The wishing-to-assign partner would get more than she would get in the admittedly "thin" market for private transactions, and the dollar value of each remaining partner's share of the partnership's NAV would increase."

COMMENT: There is considerable discussion in the opinion about the discount for lack of marketability, its components and restricted stock studies, but the bottom line is the application of Section 2703 and its huge impact on the Court's valuation conclusions. Indeed, even the IRS appraiser was at a 35% combined discount (11% and 27%) if the restrictions were taken into account.

<u>Astleford v. Commissioner</u>, T.C. Memo. 2008-128. Filed May 5, 2008.

This gift tax case involved the valuation of limited partnership interests in a family real estate partnership, one of the assets of which was a 50% general partnership interest in a partnership owning Minnesota farmland. The 50% interest was noncontrolling since each 50% general partner could not act alone.

The IRS has often argued that valuation discounts at levels below the top tier or "parent" entity are not appropriate. Here the Court allowed lack of control and marketability discounts at both levels, noting that the farmland partnership was only 16% of overall net asset value and one of fifteen real estate investments. Concluded combined discounts were 30% for the general partnership interest and roughly 35% for the limited partnership interest.

COMMENT: Judge Swift's list of favorable multi-tiered discount Tax Court cases is handy:

> *Estate of Piper v. Comm'r.*, 72 T.C. 1062 (1979).

Janda v. Comm'r., T.C. Memo. 2001-24.
Gow v. Comm'r., T.C. Memo. 2000-93, affd. 19 Fed. Appx. 90 (4th Cir. 2001).
Gallum v. Comm'r., T.C. Memo. 1974-284.

Estate of Mirowski v. Commissioner, T.C. Memo. 2008-74. Filed March 26, 2008.

Anna Mirowski formed and funded a Maryland LLC with 90% of her assets, made gifts of 16% noncontrolling interests to her three daughters' trusts, keeping a 52% majority interest as general manager, and then died. All of this occurred over a two week period. Are these facts bad enough for Code Sections 2036 and 2038 to apply? Here are some of the reasons why Judge Chiechi rejected IRS arguments that the LLC's assets should be added back to the gross estate:

- Mrs. Mirowski's eight month illness was treatable and her death was unexpected. The entire process of finalizing LLC arrangements took a little over a year.

- Among the "legitimate and significant" nontax purposes for creating the LLC were joint management of family assets, single pooling of assets to allow for more investment opportunities, and enabling children and eventually grandchildren to share family assets equally.

- Mrs. Mirowski retained sufficient assets ($7.5 million) to live on after her transfers to the LLC. An $11.8 million gift tax bill would have been paid from a combination of several sources, including personal assets, future 52% LLC distributions, and /or borrowing against same.

- The LLC was found to be a "valid functioning business operation" that had to manage matters relating to patents and a license agreement for an implantable defibrillator (the "ICD", invented by Mrs. Mirowski's deceased husband) as well as a $62 million securities portfolio.

- IRS arguments under 2036(a)(1), 2036 (a)(2) and 2038(a)(1) (retention and control of enjoyment) failed because a close reading of the LLC agreement showed that Mrs. Mirowski did not really have the authority to decide timing and amounts of distributions despite her majority interest. Furthermore, Maryland law imposed upon her fiduciary duties to other LLC members.

Estate of Jorgensen, T.C. Memo. 2009-66

Section 2036 Applied to Creation of FLPs; Equitable Recoupment Allowed to Adjust for Prior Income Tax Overpayments in Light of Increase in Basis Attributable to Increased Gross Estate Value

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Synopsis:

The Internal Revenue Service won another §2036 marketable securities FLP case. Some of the facts were not terrible — the decedent retained assets for her day-to-day living expenses. However, other facts were pretty bad — (1) there was no evidence of why one FLP was created but contemporaneous attorney correspondence referred only to estate tax savings as the reason for creating the second (and much larger) FLP, (2) the decedent had control of the FLPs' checkbooks even though she was not the general partner, and (3) she in fact wrote checks out of the partnership accounts for personal purposes (including for making annual exclusion cash gifts). Particularly notable aspects of the §2036 analysis include:

- This is yet another case where the court pointed to post-death payments of estate taxes as reflecting an implied agreement of retained enjoyment of partnership assets to trigger §2036;
- In rejecting the "bona fide" transfer defense, the court found "especially significant that the transactions were not at arm's length and that the partnerships held a largely untraded portfolio of marketable securities;" and
- In dictum, the court observed that §2036 applied even as to assets attributable to partnership interests that the decedent gave to her children and grandchildren more than three years prior to her death, reasoning that the decedent "retained the use, benefit, and enjoyment of the assets she transferred to the partnerships."

In addition, under the equitable recoupment doctrine, the Tax Court allowed an offset in the estate tax liability for the "overpayment" of income taxes, where a refund of the income tax was barred by limitations and where the prior income tax payments did not reflect the increased bases as a result of the increased value included in the decedent's estate under §2036.

The case is appealable to the Ninth Circuit Court of Appeals.

Basic Facts:

1. In mid 1995, Mr. and Mrs. Jorgensen ("H and W") contributed about $450,000 (equally from each) of their $2 million portfolio of marketable securities to an FLP (JMA-I). H and the son and daughter of H and W were general partners, but H made all decisions regarding the formation and operation of the FLP. (There was no testimony as to why JMA-I was created; W's estate later argued "that tax savings could not have been the primary factor in forming the partnerships because discounts were not used in valuing Colonel and Ms. Jorgenson's gifts of partnership interests in 1995 through 1998." However, the court noted that discounts were claimed in H's estate after his death.)
2. H died in late 1996. JMA-I was valued with a 35% discount, and H's bypass trust was funded with an interest in the partnership.
3. In late January 1997, while administering H's estate, the estate planning attorney recommended in a letter that W transfer her brokerage accounts to JMA-I, to qualify for the valuation discount and to facilitate making annual gifts, saying "[t]his is important if you wish to reduce the amount of your own estate, which will be subject to estate taxes." The attorney wrote another letter to W the following day, again recommending that she transfer the brokerage accounts of her and H's estate to JMA-I to qualify for the 35% discount, which would result in estate tax savings of $338,487.50, concluding that "there can be no discount if the securities owned by you continue to be held directly by you."

4. The attorney subsequently had discussions with the son, the daughter and her husband (but not W), and the decision was made to form a new FLP (JMA-II). A letter from the attorney to W in May 1997, said that the purpose of creating a new partnership was to have the new partnership own high basis assets, while JMA-I would hold low basis assets, and W could make future gifts from JMA-II (which would hold high basis assets).

5. JMA-II was formed in July 1997. W contributed about $2.1 million of her marketable securities (including assets bequeathed to her from H's estate), and about $500,000 of marketable securities from H's estate. W received about an 80%, and H's estate held about a 20% interest in the new partnership. The two children were general partners. The children and grandchildren (and the son-in-law) were listed as limited partners in the partnership agreement, but they did not contribute anything.

6. In 1995, 1996, and 1998, W gave about 30.6% of JMA-I to her children and grandchildren collectively. In 1997 and 1998, she gave about 6.0% of JMA-II to her children and grandchildren. (Footnote 4). [Observe: These gifts ended up being made more than three years prior to W's subsequent death; she also made gifts in 1999, but the facts stated in the opinion do not indicate whether the 1999 gifts were more than three years prior to her death.]

7. In 1999-2002, W gave 34.75% of JMA-II to her children and grandchildren collectively. (Discounts of 50% and 42% were applied in valuing some of the gifts. Gift tax returns were filed for 1999 and later years, but not earlier years.).

8. In 1998, W consulted with a different estate planning attorney about making gifts to utilize her lifetime gift exemption. In October 1998, the attorney sent W a letter observing the possibility of an audit of such a large gift "because JMA-II held only passive investments." The letter went on to state that W "had several nontax reasons for creating JMA-II, including: The ability to transfer assets without disrupting the recipient's initiative, cost savings from the pooling of assets, simplification of gift-giving, protection against creditors, protection in the case of divorce, and the education of younger family members." The court gave little weight to this letter, observing that it "was written well after the formation and funding of the partnerships by an attorney preparing for potential litigation with respect to the gift." In a footnote, the court observed that the Tax Court has previously recognized "that taxpayers often disguise tax-avoidance motives with a rote recitation of nontax purposes" (citing Hurford and Bongard).

9. Even though W was not a general partner, she was authorized to write checks on the partnership accounts. In October 1998, she wrote checks on JMA-I of over $30,000, primarily for making cash gifts. In late January 1999, W wrote a $48,500 check to her daughter from JMA-I to equalize a gift she had previously made to her son (she did not have enough cash in her personal account to make the cash gift to her daughter). (In April 1999, W deposited $30,000 plus $48,500 in the JMA-II account to "repay" the amounts she had withdrawn from JMA-I to make cash gifts, without explaining why the deposit was made to the "wrong" partnership account; there was no "indication that the error was corrected.")

10. In July 1999, the son borrowed $125,000 from JMA-II to buy a home. He did not make any payments on the loan for several years, and then just made several interest payments.

11. W also paid her 1998 estimated quarterly income tax payments of about $9000 from JMA-I. She paid about $6500 of H's estate administration expenses from JMA-II, but she later repaid that amount. W also paid H's estate income tax and various administration expenses and expenses regarding her gift tax returns, and some of her attorney's expenses from JMA-II (and those amounts were not repaid).

12. W died on April 25, 2002.

13. At the attorney's recommendation, the son repaid his $125,000 loan from JMA-II in January 2003. Also in January 2003, JMA-II paid $211,000 for W's federal and California estate tax liabilities.

14. In 2003-2006, the partnerships sold various assets that W had contributed to them. To compute the gain, the partnerships used W's "original cost basis in the assets, as opposed to a step-up in basis equal to the fair market value of the assets on Ms. Jorgensen's date of death under section 1014(a)." The partners reported the gain and paid the related income taxes. In 2008, the partners filed protective claims for refund of the income taxes, but the refund claim for the 2003 income tax payment was not timely.

Holdings

1. Section 2036(a)(1) Applied. All of the assets in JMA-I and JMA-II attributable to W's original ownership interests were included in her estate. The bona fide sale exception did not apply, and the court found an implied agreement of retained enjoyment in the partnership assets, even as to assets attributable to gifts of limited partnership interests made more than three years prior to her death (in dictum, reasoning that she retained enjoyment of all assets she had transferred to the partnerships).

2. Section 2038. The government also argued that §2038 applied. The court did not summarize the government's argument and refused to address the §2038 issue in light of the fact that the assets were included in the estate under §2036(a)(1).

3. Equitable Recoupment. An offset in the amount of additional estate tax due was allowed for the "overpayment" of income taxes, where the prior income tax payments did not reflect the increased basis as a result of the increased value included in the decedent's estate under §2036.

Court's Analysis

1. Burden of Proof. The court did not decide whether the burden of proof shifted to the government, because its resolution was based on a preponderance of the evidence rather than on whether either party met its burden of proof.

2. Section 2036 Overview. Section 2036 requires three elements: (1) an inter vivos transfer, (2) that was not a bona fide sale for full consideration, and (3) in which the decedent retained an interest or right described in §2036(a)(1) or (2) or (b). The transfer requirement is satisfied by W's voluntary contributions to the partnerships. The balance of the §2036 analysis addressed the last two elements.

3. Bona Fide Sale Exception Not Applicable.

    a. Purported Nontax Reasons Not Recognized. The court did not view any of the nontax reasons stated in the after-the-fact letter by the estate planning attorney as being "legitimate and significant nontax reasons." (The letter is quoted in Item 8 of the Basic Facts section of this summary.)

    - Management Succession. Prior cases (Kimbell and Mirowski) that recognized efficient management as a nontax reason involved assets requiring active management, unlike this portfolio of marketable securities in which there was very little trading after H's death. Also, the FLPs were not needed to manage assets for W's benefit because her revocable trust and power of attorney could have been used to provide management of her assets.

- Financial Education of Family and Promoting Family Unity. H made all decisions during his lifetime and did not teach his children about investing. The failure to involve his children suggests that promoting family unity was not "anything more than a theoretical purpose." In fact, the partnerships could cause family disunity between the son and daughter because of their different spending habits (the son was a spendthrift and the daughter was frugal).
- Perpetuate Investment Philosophy and Motivate Participation. The Schutt case, which recognized implementing a "buy and hold" investment philosophy as a legitimate nontax reason, was distinguished because that case (involving the duPont family) addressed retaining "stock traditionally held by the family" including stock held in trust after those trusts terminated. (Footnote 10). The "motivating participation" reason is unconvincing because H did not include the children in decisions and limited partners are precluded from participating in decision-making.
- Pooling of Assets. As to pooling for W's benefit: W had no involvement in managing the assets or in the decision to transfer assets to JMA-I, so pooling was not a significant purpose of JMA-I. There is no credible evidence that W wished to pool her assets in JMA-II.

  As to pooling for the benefit of children and grandchildren: There is little evidence that economies of scale or better service followed from pooling of assets. The children and grandchildren would have received the same attention from the investment advisor by just linking their accounts.
- Creditor Protection. Taxpayers asserted spendthrift concerns, particularly about possible divorces, unwise spending by minors, and the son's free spending habits. However, the son was the general partner and he accessed partnership assets by a loan. Like other prior cases that have rejected the creditor protection reason, the court emphasized that there were not any particular creditor problems, and this was just a theoretical concern.
- Providing for Children Equally and Facilitating Gift-Giving. Facilitating and simplifying gift-giving is not recognized as a significant and legitimate nontax reason (citing Bongard and Bigelow).

b. Factors Indicating Not Bona Fide. The court emphasized several reasons suggesting that the primary purpose of the partnerships was saving taxes.

- Contemporaneous Advice Referred to Tax Savings. Advice given at the time the partnerships were formed all pointed to tax savings is the reason. A letter offering purported nontax reasons over a year later was given little weight.
- Disregard of Partnership Formalities. No books and records were maintained. There were no formal meetings of partners and minutes were never kept. W and her children often failed to respect the partnerships, paying personal expenses and mingling personal funds with partnership funds. Financial dependence on the partnership for making cash gifts and various non-pro rata distributions are further evidence of the disregard of formalities.
- No Arms Length Transfers. "When a taxpayer stands on both sides of a transaction, we have concluded that there is no arm's length bargaining and thus the bona fide transfer exception does not apply." (Citing the Strangi and Harper Tax Court cases.)

JMA-I: H made all decisions regarding JMA-I, so transfers of assets to it were not made at arm's length.

JMA-II: W funded JMA-II through her revocable trust and as executrix of H's estate, and the decision was made largely by her children. "Considering that Ms. Jorgensen stood on both sides of the transaction, although in different roles, we conclude that the transfer of assets to JMA-I was not at arm's length."

- Conclusion. "We find *especially significant* that the transactions were not at arm's length and that the partnerships held a largely untraded portfolio of marketable securities." (emphasis added) [Observation: This is the first court case that applies this much importance to the "arm's length" factor.]

c. Full Consideration Conceded. The government did not repeat its argument from prior cases that there was not full consideration when the decedent received a limited partnership interest worth less than the value of assets that she contributed. [Observe: The government apparently is now conceding this issue (at least in Tax Court cases), and the court restated the proportionality test of Kimbell and Bongard.]

4. Section 2036(a)(1) Implied Agreement of Retained Enjoyment.

a. Decedent Retained Assets for Living Expenses. The court acknowledged that W "retained sufficient assets outside the partnership for her day-to-day expenses."

b. Partnership Assets for Personal Expenses (Primarily to Make Gifts). W wrote various checks on the partnerships for her personal expenses and for expenses of H's estate administration. The court pointed primarily to her need for cash from partnerships to make cash gifts. (The court did not specifically mention payments of the partners' income taxes in this portion of the opinion.)

c. Post-Death Payments from Partnership. The court highlighted post-death distributions of $179,000 and $32,000 used to pay transfer taxes, legal fees, and other estate obligations. "The use of a significant portion of partnership assets to discharge obligations of a taxpayer's estate is evidence of a retained interest in the assets transferred to the partnership" (citing the Rosen, Korby, and Thompson Tax Court cases and the Strangi Fifth Circuit Court of Appeals case). [Observe: For some reason, the court did not cite the Erickson case, which seems to point almost exclusively to post-death payments as creating the implied agreement of retained enjoyment under §2036(a)(1).]

d. Substantial Amount Distributed in Non Pro Rata Distributions. The "actual use of a substantial amount of partnership assets" to pay pre-death and post-death obligations supports the finding of an implied agreement of retained enjoyment. Furthermore, even charging such distributions against the decedent's share of the partnership would not have helped: "This is true regardless of whether the distributions were charged against her percentage interest in the partnerships, and especially relevant considering that under the terms of the partnership agreements all distributions were to be pro rata."

e. Fiduciary Duties to Decedent Further Evidence of Implied Agreement. The son and daughter were general partners of the partnerships and were also co-trustees of W's revocable trust. As co-trustees, they had the duty to administer the trust solely for W's benefit, and their investment of trust assets in the FLPs in light of this fiduciary duty to W is further evidence of an implied agreement of retained enjoyment by W of assets contributed to the FLPs.

5. Section 2036 Applied Even As to Assets Attributable to Partnership Interests Given More Than Three Years Prior to Death. In objecting to one of the government's proposed finding of facts, the estate stated that if §2036 applied, it should only apply to assets that W held on the date of her death plus transfers made within three years. The court concluded (in footnote 13) that the estate waived or abandoned any claim that assets attributable to gifts of partnership interests made more than three years prior to her death should not be included under §2036 by failing to argue the issue beyond a vague assertion within an objection to a proposed finding of fact. In dictum, the court stated that even if the issue had not been waived, "we would not find that Ms. Jorgensen terminated a portion of her interest in the partnership assets. The record indicates that Ms. Jorgenson retained the use, benefit, and enjoyment of the assets she transferred to the partnerships." [Observe: The court reached that conclusion even though the decedent apparently never made payments from the partnership that exceeded her pro rata value of partnership assets. From a planner's perspective, this dictum may be the scariest aspect of this case, suggesting that assets attributable to partnership interests transferred long before the decedent's death could be brought back into the estate under §2036(a)(1) by finding an implied agreement of being able to access all partnership assets, even those attributable to interests that had been sold or given to other individuals.]

6. Equitable Recoupment. An amendment in 2006 to §6214(b) allows the Tax Court to apply the doctrine of equitable recoupment. The court analyzed the four elements of the equitable recoupment doctrine: "(1) The overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period of limitation; (2) the time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) the transaction, item, or taxable event has been inconsistently subjected to two taxes; and (4) if the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one."

   a. Overpayment Barred by the Statute of Limitations. A refund of the income taxes for 2003 was barred by the statute of limitations, so the doctrine can apply with respect to the overpayment of income taxes in 2003.

   b. Overpayment Arose Out of A Single Transaction. This requirement was met because the same item that was included in the gross estate was the item that was sold and generated the gain that produced the income tax overpayment.

   c. Subject to Two Taxes Inconsistently. The court reasoned that the increased basis as a result of including additional value in the decedent's gross estate should result in decreased gain recognition. [Observe: The taxpayer may have been fortunate as to this element. The opinion indicated that the amount of the taxable gain in 2003 was computed based upon W's original basis rather than on a stepped-up basis under §1014. Based on the reporting position taken (i.e., not computing gain based on a stepped up basis under §1014), the amount of the 2003 income tax arguably is not inconsistent with an increase in the gross estate value. Furthermore, the facts do not make clear whether a §754 election was in effect for the partnerships; if not, there would not have been an increase in the "inside basis" of the partnership assets by reason of the death of a partner.]

   d. Sufficient Identity of Interest. The court reasoned that it does not matter that the grandchildren, who also paid some of the increased income tax, are not liable for the estate tax attributable to inclusion of additional value under §2036. "[T]he relevant caselaw does not indicate that the taxpayer who overpaid tax must be the one responsible for the related deficiency for equitable recruitment to apply."

e. Conclusion. "It would be inequitable for the assets to be included in the value of Ms. Jorgensen's gross estate under section 2036 on the one hand, and on the other hand for the estate not to recoup the income taxes her children and grandchildren overpaid on their sale of those very same assets but are unable to recover in a refund suit." The court allowed the recoupment of the overpayment of 2003 income taxes attributable to additional basis step-up allowed under §1014 because of the §2036 inclusion of partnership assets in the gross estate.

Observations

1. Cannot Avoid §2036 By Merely Retaining Assets for Living Expenses. Planners should not fall into the trap of thinking that by merely having a client retain sufficient assets for living expenses that §2036 (a) (1) can necessarily be avoided.

2. Non Pro Rata Distributions to Pay Decedent's Personal Expenses. The key item evidencing an implied agreement of retained enjoyment in this situation was the actual payment of personal expenses of the decedent (primarily to make cash gifts and also to pay post-death expenses) in a non-pro rata manner.

3. Post-Death Payments of Estate Taxes and Administration Expenses. The court pointed very explicitly to the payment of estate taxes and other administration expenses as evidencing an implied agreement of retained enjoyment. It would seem that the use of partnership assets after death is irrelevant as to the retained right to enjoy assets under §2036 "for life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death." However, there is a growing number of cases that have now looked at post-death partnership payments to trigger §2036(a)(1). The court quoted the Fifth Circuit's statement that "part of the 'possession or enjoyment' of one's assets is the assurance that they will be available to pay various debts and expenses upon one's death." Strangi, 417 F.3d at 477.

   Interestingly, the court did not cite the Erickson case, in which the only distributions from the partnership for the benefit of the decedent were the post-death payment of taxes. T.C. Memo. 2007-107. In Erickson, the court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Ericsson (or the estate) could use the assets if needed."

   What if there are non-liquid assets in the estate and insufficient liquid assets for paying all post-death expenses? John Porter's recommendations (from presentations at various seminars):

   (a) It is best is to borrow from a third party, but a bank may be unwilling to do that using only the partnership interest as collateral.

   (b) Borrow from an insurance trust or a family entity, secured by the partnership interest.

   (c) There are three options for utilizing partnership funds: redemption, distribution or loan. Erickson involved a purchase of assets and redemption but the court still held against the taxpayer. Pro rata distributions are a possibility, but if they are made on an "as needed basis" that plays into IRS's hands on the §2036 issue; the estate can argue that distribution for taxes are made all the time from partnerships, but usually income taxes. If the partnership assets must be used directly to pay taxes, John prefers borrowing from the partnership on a bona fide loan, using the partnership interest as collateral. It is best to use a commercial rate rather than the AFR rate (that looks better to the government as an arm's length transaction). Also, consider using a Graegin loan — with a fixed term and a prohibition on prepayment. The IRS is looking at Graegin loans in FLP audits, but John has used them successfully in a number of cases.

[Some attorneys suggest that the preferred approach is to have other family members or family entities purchase some of the decedent's partnership interest to generate cash flow to the estate for paying post-death expenses. The partnership assets would not be utilized at all under that scenario.]

4. Actual Operation of Partnership Critical in Reviewing Nontax Reasons. Despite the fact that the nontax reasons for creating the partnership was described in a letter written more than a year after the partnerships were created, the court focused primarily on the fact that the actual operation of the partnerships was not consistent with the purported nontax reasons.

5. Partnership Interests Transferred More Than Three Years Before Decedent's Death. If an individual relinquishes within three years of death an interest or power that would cause estate inclusion under the "string" statutes, the assets are still included in the gross estate under §2035. Conversely, if an interest or power that causes estate inclusion under the string statutes is relinquished more than three years before death, §2035 does not apply. It is understandable that if a decedent retains control over partnership assets that causes estate inclusion under §2036(a)(2) or 2038, the three-year rule should not come into play, because the decedent still actually has that degree of control at his or her death. However, it would seem that the answer would be different if §2036(a)(1) is being considered, because it depends on retained enjoyment of assets, and under state law a partner is not entitled to assets attributable to partnership interests that the decedent does not own. In fact, distributions of partnership assets that cannot be attributed to the decedent's interest in the partnership would be theft or an illegal diversion of property from the rightful owners. Nevertheless, a troublesome number of courts have now concluded that a decedent retained personal enjoyment of all partnership assets, even those attributable to interests that were transferred more than three years prior to the decedent's death. The court's analysis of this issue in Jorgensen is dictum; nevertheless, the court makes clear that it would have found that the decedent retained enjoyment of all partnership assets attributable to her original contributions, even though there were apparently never any distributions for the decedent's benefit in excess of her pro rata value of the partnership assets.

   Other examples where the decedent was found to have retained personal enjoyment of the FLP assets even after limited partnership interests had been given away were the Estate of Korby and Estate of Rosen cases, Even though the gifts in the Korby cases may have been made more than three years before death, that apparently was irrelevant because the court found the existence of an implied agreement to retain enjoyment of all of the income of the partnership even after the limited partnership interests had been given away. 471 F.3d 848 (8th Cir. 2006). Similarly, the Rosen case held that all partnership assets were included even though the decedent had given away substantial partnership interests more than three years before her death. She was the only partner to receive cash flow from the partnership, and the court concluded very simply that §2035 was not relevant because "Decedent continued to possess and enjoy the transferred assts up until her death." T.C. Memo. 2006-115. See also Estate of Bigelow (all FLP assets included under

§2036 even though decedent made gifts of over 50% of the limited partnership interests by the time of his death).

The obvious planning implication is that following gifts of partnership interests, only proportionate distributions should be made, and nothing should be done to create any implication that the decedent will receive any distributions of partnership assets attributable to previously transferred partnership interests. Furthermore, in light of the inherent §2036(a)(1) uncertainty that can arise by mere implied agreement based on the court's interpretation of the facts, planners may want to consider advising clients who have successfully transferred substantial interests in an FLP to terminate the FLP to remove any possible taint of retained enjoyment of partnership assets that are attributable to transferred partnership interests. If the court would find the existence of a retained enjoyment in all partnership assets, the client would have to live three years after the partnership termination to avoid §2035, but at least the three period could begin running to close the books on the possible application of §2036 to the prior successful transfers. (Of course, the termination of the partnership would be inconsistent with the nontax purposes of the partnership; a reasonable reply would seem to be that the family hates giving up the nontax benefits of the FLP, but it is forced to do so because of the possible tax disadvantages of continuing the FLP.)

6. Practical Planning Pointers From Jorgensen.

   a. Documentation of Nontax Purposes. Correspondence or advice given contemporaneously with the creation of the partnership should refer to the nontax reasons for the partnership. Saving estate taxes should not be the overriding primary purpose for creating the partnership in order to avoid §2036. In Jorgensen, tax savings (and facilitating gift-giving to save taxes) were apparently the only reasons discussed when the partnerships were created. Under the statutory language of §2036, having nontax reasons should be unimportant if the decedent does not retain interests or powers that would trigger §2036(a)(1) or (2). However, so far, every court that has concluded that there were no legitimate nontax reasons has also managed to find some interest or power that would trigger §2036(a)(1)(or (a)(2).

      Furthermore, as discussed in Item 4 above of these "Observations," the court will scrutinize whether the partnership is actually operated in a way that implements those nontax reasons.

   b. Avoid Non Pro Rata Distributions for Paying Personal Expenses. The court concluded that that an implied agreement of retained enjoyment existed in large part because of the actual non pro rata payments from the partnerships for the decedent's personal uses. If possible, avoid making any distributions to avoid assisting the government in making an implied agreement of retained enjoyment argument. At the least, only make pro rata distributions, and make the distribution decisions based on factors relating to the partnership assets and not based on the personal needs of the partners.

   c. Keeping Sufficient Assets to Pay Living Expenses Is Not a Safe Harbor Around §2036(a)(1). Do not assume that §2036(a)(1) can be ignored just because the client retains sufficient assets to pay his or her normal living expenses.

   d. Control of Partnership Checkbook. It looked extremely suspicious in Jorgensen that the decedent retained the enjoyment of partnership assets when she could (*and did*) write checks on the partnership account even though she was not a general partner.

   e. Involve Others in Negotiations. In light of the court's emphasis on the importance of arm's length transactions (more than any other court so far), planners may want to place more emphasis on having meaningful negotiations when partnerships are created. Consider having some third party partners at the outset who can enter into negotiations. If there are not other family members as partners from the outset, include family members who may receive interests in the future (by gift, sale, investment in the partnership, or bequest) in the negotiations. The parent may wish to pay for an attorney to represent the other partners to facilitate actual bargaining and negotiation. It would seem to be particularly helpful if meaningful revisions were made to the partnership structure or partnership investments in light of the negotiations.

f. Investment Changes. The court, in its final statement of what particularly troubled the court, pointed to the lack of negotiations and the fact that the partnership consisted of a "largely untraded portfolio of marketable securities." After the creation of the partnership, it is helpful if there are changes in the investment mix. If possible, the partnership might even considering purchasing assets other than marketable securities with a portion of its assets.

g. Satisfying Qualified Purchaser and Accredited Investor Rules. A very real concern of many wealthy families is that the parents have sufficient wealth to qualify as "qualified purchasers" (which generally requires that individuals have $5 million of net "investments" — not including the home or assets that are not held for investment) and "accredited investors" and are able to invest in unregistered securities, but their children may not. Pooling of assets in this situation, to allow the flexibility of future investments in such opportunities if they arise, is an important nontax reason for pooling investments in a partnership. That reason apparently did not exist in the Jorgensen situation, but if it applies in another family situation, highlight that nontax reason. (Consistent with the prior statements, it would be helpful if that reason gets implemented under the actual operation of the partnership if the opportunity arises for the partnership to invest in such an investment requiring qualified purchasers or accredited investors.)

h. Investment by Fiduciary of Revocable Trust. The court pointed out that investment in an FLP by a revocable trust for the decedent, where she had the right to access trust assets at any time, was one indication of an implied agreement that the partnership assets could be used for the decedent's benefit. This factor was more sensitive under the Jorgensen facts where the co-trustees of the revocable trust were also the general partners of the FLP.

i. Insulate Spendthrift From Distribution Decisions. If part of the reason for creating an FLP is because of creditor concerns for a particular partner who is a spendthrift, do not name that person as a general partner with authority over distributions.

k. File Protective Claims for Refund If Gain Recognized Attributable to Hard-To-Value Assets in an Estate. The Jorgensen family could have avoided having to make the equitable recoupment argument (which it may have been fortunate to win) if it had just filed a timely protective claim for refund with respect to income taxes paid with respect to the sale of partnership assets. Whenever taxable gain is recognized from the sale of assets that might possibly be subject to scrutiny (either inclusion or valuation) in an estate tax audit, the persons who pay the income tax should file a protective claim for refund in case the estate tax audit results in an increased value, which would therefore result in an increased basis. (For a partnership, this issue should only arise for a sale of partnership assets if the partnership has a §754 election in effect at the death of the relevant partner, which would then result in an increase of the "inside basis" of the partnership in the partnership assets.)

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U.S. employers must begin using the revised U.S. Citizenship and Immigration Services (USCIS) Employment Eligibility Verification Form known as the I-9 (Form I-9) on April 3, 2009. Meanwhile, certain federal contractors and subcontractors also must prepare to comply with impending requirements to use USCIS E-Verify when hiring employees scheduled to take effect May 21, 2009.

New Form I-9

The use of the new Form I-9 is required under an interim rule published by USCIS in December 2008. The interim rule also changes the types of acceptable identity and employment authorization documents employers can accept from new hires and prohibits employees from using expired identification documents to verify their work eligibility beginning April 3, 2009. Employers will be required to use the new Form I-9 and to secure documentation of proof of eligibility to work in accordance with the revised rules contained in the interim rule for all new hires and to reverify any employee with expiring employment authorization in accordance with the interim regulations beginning on April 3, 2009.

Employers can download a copy of the new Form I-9 at http://www.uscis.gov/files/form/I-9_IFR_02-02-09.pdf. The interim regulations are available for review at http://edocket.access.gpo.gov/2008/E8-29874.htm. USCIS presently is updating the Handbook for Employers, Instructions for Completing the Form I-9 (M-274).

The new Form I-9 replaces the June 5, 2007 edition of the Form I-9 (the Old Form I-9), which will not be valid for use after April 2, 2009. A big change in the new Form I-9 requirements is that expired documents cannot be accepted as proof of eligibility to work. All documents presented during the Form I-9 completion process now must be unexpired. The new Form I-9 and interim regulations also add and remove certain documents to the list of documents that employers can accept of proof of identity and/or eligibility to work in the U.S.

The interim rule originally was scheduled to take effect on Feb. 2, 2009. The Obama Administration extended the effective date to April 3, 2009 under a directive issued in January.

Federal Contractor E-Verify Rule Scheduled To Take Effect May 21, 2009

Certain federal contractors and subcontractors also need to prepare to comply with a new federal rule that will require them to use E-Verify to verify the employment eligibility of new hires scheduled to take effect May 21, 2009. The rule will only affect federal contractors who are awarded a new contract after May 21st that includes the Federal Acquisition Regulation (FAR) E-Verify clause. Federal contractors may **NOT** use E-Verify to verify current employees until the rule becomes effective and they are awarded a contract that includes the FAR E-Verify Clause.

The new rule implements Executive Order 12989, as amended by President George W. Bush on June 6, 2008, directing federal agencies to require that federal contractors agree to electronically verify the employment eligibility of their employees. The amended Executive Order reinforces the policy, first announced in 1996, that the federal government does business with companies that have a legal workforce. This new rule requires federal contractors to agree, through language inserted into their federal contracts, to use E-Verify to confirm the employment eligibility of all persons hired during a contract term, and to confirm the employment eligibility of federal contractors' current employees who perform contract services for the federal government within the United States.

Interested persons can review the final regulation and read frequently asked questions about this new rule on the internet at the following cites:

- ✓ Final Regulation at http://edocket.access.gpo.gov/2008/E8-26904.htm
- ✓ Frequently Asked Questions at http://www.uscis.gov/portal/site/uscis/menuitem.5af9bb95919f35e66f614176543f6d1a/?vgnextoid=cb2a535e0869d110VgnVCM1000004718190aRCRD&vgnextchannel=75bce2e261405110VgnVCM1000004718190aRCRD

If you have questions or concerns about the matters discussed in this publication or other human resources, employee benefits or compensation matters, wish to obtain information about arranging for training or presentations by Ms. Stamer, wish to suggest a topic for a future program or publication, or wish to request other information or materials, please contact Ms. Stamer via telephone at (214) 270-2402 or via e-mail to Cstamer@Solutionslawyer.net. .

More Information

We hope that this information is useful to you. You can register to receive future updates and information about upcoming programs, access other publications by Ms. Stamer and other helpful resources or additional information about Ms. Stamer at CynthiaStamer.com or by contacting Ms. Stamer directly. If you or someone else you know would like to receive updates about developments on these and other human resources and employee benefits concerns, please be sure that we have your current contact information – including your preferred e-mail- by creating or updating your profile at CynthiaStamer.com. You also can register to participate in the distribution of these updates by registering to participate in the Solutions Law Press HR & Benefits Update Blog at http://slphrbenefitsupdate.wordpress.com.

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The Paperless Law Office: Creating an Electronic Closing Binder

By Tonya Johnson

Even a simple real estate closing can result in a number of closing documents. Complex transactions involve many more documents and ancillary items, such as title policies, surveys and insurance certificates.

Adobe Systems created the Portable Document Format (PDF) technology in 1993 for document exchange. Since that time, PDF has emerged as the de facto standard for sharing electronic documents due to its portability, accessibility and security. PDF files maintain the look of the native file, can be viewed on any Macintosh, PC, or Unix computer and are universally available to every computer user at no cost through the free Adobe reader. Of particular note to lawyers, shared files can be password protected, with permissions that limit the ability to print or alter the document; and Metadata and other sensitive information can be removed. More specifically for real estate lawyers, Adobe Acrobat can help streamline the labor intensive process of creating closing binders.

In a typical preparation for a real estate closing, a paralegal or other staff member is taking up valuable desk (and sometimes floor) space to organize and assemble documents to include in the closing binder. The printer is churning away to the exclusion of any other work as one or two staff people scramble to complete the binder for presentation to the client. The creation of these binders can be time-consuming, labor intensive and costly. If you have been considering cost-cutting measures, creating greater efficiencies and adding value to your practice, now may be a good time to consider creating electronic closing binders.

A professional version of Acrobat can help your staff create an electronic closing binder that can reduce the material and labor costs associated with physically printing and assembling a closing binder. An electronic binder can be even more valuable to your client due to its portability and the accessibility and searchability of the associated documents. If hard copies are needed, the specific documents can be printed by the client at his or her convenience, thus saving space, ink and paper. An electronic closing binder will fit nicely into your document management system. Resources previously dedicated to closing binder assembly can be more effectively used. Moreover, electronic closing binders carry the added bonus of being environmentally friendly. Your firm can join the "green" law movement that appeals to many clients while benefitting your bottom line.

An electronic closing binder can be created in Adobe Acrobat as a Binder or Portfolio document. Binders are likened to digitally stapled documents that accommodate a variety of files (for example Microsoft Word, Excel spreadsheets or scanned documents) by converting them to PDF format for easy review and collection. The Portfolio expands on the Binder format and is likened to a briefcase. The Portfolio document retains each document's native file format. Portfolios include greater security options, digital signatures and the option of subfolders for easier document organization, as well as a branding option that allows you to include the firm logo within the Portfolio for a more polished presentation. Both formats allow for the creation of a Table of Contents and bookmarking for easier navigation of the documents and quick access to key documents in anticipation of post-closing events.

The resources below will connect you to free instruction and documentation that will increase the returns on your Adobe investment while using less paper.

Resources

Creating Electronic Closing Binders using Acrobat 9 is the subject of a blog post by Rick Borstein, Business Development Manager for Acrobat in the Legal Market for Adobe Systems. The post refers to:

- A 1-hour eSeminar on Closing Binders that demonstrates both the binder and portfolio formats as well as the strengths of each format and which versions of Acrobat will allow you to take advantage of these features.
- A 36-page guide entitled Creating Electronic Closing Binders using Acrobat 9 that you can download and review at your convenience. The guide recaps the material covered in the online Seminar and serves as a quick reference document that clearly illustrates how to get up to speed in creating electronic closing binders.

Adobe's Legal Landing Page – Details the key features in Acrobat 9 of particular interest to legal professionals.

The Acrolaw Blog is a resource for the legal community published by Rick Borstein, an Adobe Certified Expert in Acrobat and a member of the American Bar Association. The blog provides tips, instruction and information to maximize your Acrobat investment and keep you up to date regarding scheduled live and online presentations conducted by Adobe.

Lawyers weigh in on the use of PDF and Adobe Acrobat

The following are some comments from lawyers on their experience using PDF and Acrobat.

> PDF for Lawyers – Attorney Ernest Svenson blogs about using PDFs in the practice of law.
>
> A discussion on using Adobe Acrobat with YourABA and David L. Masters, author of "The Lawyer's Guide to Adobe Acrobat," – Discusses some of the unique characteristics of the software that are especially useful for lawyers.

These references should aid you and your staff in creating electronic closing binders.

Tonya Johnson is a Research Specialist with the American Bar Association Legal Technology Resource Center

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International Tax Planning Committe

Volunteer to Work On Current Projects!

The International Tax Planning Committee is currently working with the Tax Section to finalize comments to the IRS and Treasury Department on the new Exit Tax (IRC Section 877A) and the new Succession Tax (IRC Section 2801). In addition, the Committee is working with an AICPA task force to develop Form 1041NR for US taxpayers to report distributions and income from foreign trusts, and is collaborating with other AICPA task forces in order to better represent the interests of practitioners and their clients regarding offshore compliance and expatriation. Also, at the Income & Transfer Tax Hot Topics Roundtable at the Spring Symposia, the Committee will present an update regarding international estate planning and offshore investments under the new administration.

If you would like to get involved with one or more of our current projects, please email Chair Leigh-Alexandra Basha (leigh.basha@hklaw.com), Vice-Chair Michael A. Spielman (Michael.Spielman@ey.com), or Vice-Chair Rana H. Salti (Rana.Salti@kinshiptrustco.com). View our Committee webpage for more information, http://www.abanet.org/dch/committee.cfm?com=RP561500.

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The Charitable Planning and Organizations Group

The Group's three committees - Charitable Planning, Charitable Organizations, and Legislative and Regulatory Issues - work closely together in program planning and implementation.

This year the Group is working hard to sponsor quarterly calls for members that bring real insights from practitioners in the field. On January 21, 2009, Conrad Teitell led the quarterly call, discussing early termination of charitable remainder trusts. Quarterly calls are a good opportunity for members to learn about the activities of the group and to provide input on upcoming projects and programs.

The Group is sponsoring two panels at the Spring Symposia in Washington, DC: the first, focusing on new developments in the field, will be presented by Emily M. Lam, Office of Tax Policy, Department of the Treasury; Stephanie Casteel, King & Spalding LLP; Elaine Waterhouse Wilson, Quarles & Brady, LLP; and Grace Allison, The Northern Trust company. We will hear the latest on supporting organizations, the new Form 990, and the new charitable gift substantiation requirements. For our second panel, Julie Kwon, Stanford University, and Ramsay Slugg, U.S. Trust – Bank of America Private Wealth Management, will focus on CRT planning in the new tax and economic environment and on "sick" CRTs and exit strategies.

During the past few years, much of the Group's work has been responding to requests for comments from the Treasury Department on proposed regulations. The Group submitted comments on the Advanced Notice of Proposed Rulemaking on supporting organizations in 2008 and has assembled a task force to review the proposed regulations from Treasury when they are issued. This year the Group is also making new developments a priority and is updating the website to provide timely information on recent charitable cases, rulings, and regulations.

The charitable field is active and changing. We encourage members to join the Group luncheon meeting on Friday, May 1 at the Spring Symposia , meet the Group leadership, and find a project that interests you.

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Social Security Administration Issues Revised POMS on Special Needs Trusts

by: Kristen M. Lewis
Smith, Gambrell & Russell, LLP

In January 2009, the SSA issued some long-awaited updates to its staff policy manual (known as the "Program Operations Manual System" or "POMS") pertaining to the treatment of Special Needs Trusts ("SNTs") for purposes of means-tested government benefits such as Supplemental Security Income and Medicaid. Significant revisions to three POMS sections appear in SI 01120.200, SI 01120.201 and SI 01120.203 (highlighted in yellow at these links).

Of particular note to practitioners who deal regularly with SNTs are the provisions set forth in POMS SI 01120.203.B.2, which seem to formalize as a new national policy a controversial position previously espoused by the Boston Regional Office in May 2008. This revised POMS section states that while assets held in a "pooled" SNT account under 42 U.S.C. §§ 1917(d)(4)(C) and 1396p(d)(4)(C) will not be counted as a resource of an account beneficiary who is age 65 or older, the *transfer* of assets to the (d)(4)(C) SNT "may result in a transfer penalty (*see* SI 01150.121)." The newly revised POMS section retains from the prior version an acknowledgement that the federal statute authorizing (d)(4)(C) SNTs contains "no age restriction." Nevertheless, numerous state Medicaid agencies have already amended their State Medicaid Manuals to adopt the position that transfer penalties *will* apply if a (d)(4)(C) SNT account is funded with the assets of a beneficiary who is age 65 or older. This is a hotly debated issue. The Long Term Care, Medicaid and Special Needs Trusts Committee of the Elder Law, Disability Planning and Bioethics Group welcomes the input of Committee and Section members as it considers preparing a position statement on this new development.

On a positive note, the revised POMS expressly endorse the concept of a "seed" SNT established by the parent or grandparent of a legally competent disabled adult, and funded with nominal assets provided by the parent or grandparent. Approval of this seed SNT concept is now included in POMS SI 01120.203.B.1.f and 01120.203.B.1.g. Prior to the issuance of the revised POMS, staff at the National SSA office in Baltimore had unofficially recommended the use of a seed SNT by practitioners preparing a SNT for a legally competent, yet disabled, adult under 42 U.S.C. §§ 1917(d)(4)(A) and 1396p(d)(4)(A). Once the seed SNT is established, the legally competent adult may then transfer his own assets to the SNT, as may any person with legal authority over the adult's assets, *e.g.* an agent acting pursuant to a power of attorney. The revised POMS sections noted above also indicate that a seed SNT may be unfunded "if State law allows." In light of the vagaries of State law, practitioners should be wary of utilizing an "empty" or "dry" seed SNT, since compliance is easily established with a nominal funding amount, *e.g.* $10.

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Residential, Multi-Family and Special Use Group

The Group, chaired by Marjorie Bardwell and with Mark Hartman as vice chair, has four committees. At the Spring Symposia in D.C., the Group will present a panel on the effect of the current credit crunch on the various types of housing that each of its committees covers.

The Residential Housing Committee, chaired by Kellye Clarke, has sponsored an *eReport* article by a committee member on the new RESPA rules, which in turn became the basis of both the free Group teleconference in January and a more in depth CLE presentation in February that was very well received.

Stephanie M.M. Smith and Jasleen Anand, the chair and co-vice chair of the Affordable Housing Committee, participated in an excellent panel presentation at the ABA Mid Year meeting in February in Boston.

The Multi-Family Housing Committee, which is chaired by Scott Hildebrand, is participating in the panel discussion at the Spring Symposia and will host the Group teleconference this July.

We urge anyone with an interest in housing to explore our committees on the Section website, join in and participate at any and all levels. With the emphasis on the housing market in today's economy, any ideas for *eReport* articles, e-CLE programs, and materials for other Section publications are always welcome and especially timely. Please do not hesitate to contact any of the Group or Committee leaders if you have any questions.

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Practice Management Group

Ongoing Activities

The Practice Management Group has four committees: Economics, Technology and Practice Methods; Ethics and Professionalism; Real Property Litigation and Alternative Dispute Resolution; and Pro-Bono. The Group focuses on issues that can enhance the effectiveness and profitability of the legal practice of real estate lawyers. The work product of the committees deals both with the management of the real estate practice, such as ethics issues, techniques for managing offices and technology to produce legal product more effectively, and handling litigation matters effectively, whether through traditional litigation or creative alternative dispute methods. The Pro-Bono Committee provides CLE materials and articles on issues affecting legal consumers, such as predatory lending, and also has created a mechanism for RPTE attorneys to provide direct pro bono legal services through Habitat for Humanity offices nationwide.

The Group Program at the Spring Symposia is **Subprime Mortgage Meltdown, Turning Down The Heat, Part II**, on Thursday, April 30, at 1:30-3:15 p.m. The speakers will be addressing a variety of issues involved in representing residential lenders and borrowers in the current default and foreclosure crisis. The speakers are: William Freivogel (Vice Chair, Ethics and Professionalism Committee); Ann Fulmer; Howard Goldman; Eric Mathis (Vice Chair, Real Property Litigation and Alternative Dispute Resolution Committee); and Ira Reingold.

In addition, at the Spring Symposium, Chris Smart (Chair, Real Property Litigation and Alternative Dispute Resolution Committee) is the program chair for **The Land Sales Battle: Sellers and Purchasers War Over the Interstate Land Sales Full Disclosure Act** on Friday, May 1, at 3:00-4:00 p.m. The speakers are: Marc DeCandia; Rebecca Fischer; Richard Linquanti; Dan Orvin; and Leslie Schultz-Kin.

The quarterly Group conference call for May will be led by Jerry Hoenig and Maurice Pianko (respectively the Chair and Vice Chair of the Economics, Technology and Practice Methods Committee, respectively) and will focus on two topics: 1) use of the new filtered version of the very popular Solozez list serve; and 2) online backup of computer files. This call will be held at 4:00 p.m., Eastern Time, on May 28, and the call-in number and password will be available in advance and posted on the RPTE website.

We encourage RPTE members to join the Group luncheon meeting on Friday, May 1 at the Spring Symposia, meet the leadership for our Group and our Committee, and find a project that interests you. There are many opportunities for participation in the Group and we welcome participation in live presentations, articles, and e-CLE programs, or just being part of a committee.

ABA SECTION OF REAL PROPERTY | TRUST & ESTATE LAW

eReport

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Group and Committee News

2009 Fellows Program

The Fellows Program of the Real Property, Trust and Estate Law Section was designed to increase the participation of young lawyers in Section activities. The goal of the program is to give young lawyers an opportunity to become involved in the substantive work of the RPTE Section, while developing into future leaders. The Fellows gain a considerable amount of knowledge about the work of the Section, as well as the real property and trust and estate law practices.

The Fellowship appointment is for two years. To be considered for selection, a person (1) must have practiced in the trusts and estates or real property area for at least one year (and be younger than 36 years of age or have been admitted to the bar less than 10 years) and (2) should have demonstrated leadership at the state or local bar level or in the Young Lawyers Division of the ABA. As part of the Section's commitment to diversity, one half of the Fellows selected will be minority applicants. Each Fellow will receive an expense reimbursement budget and invitations to certain leadership events.

For a full description of the roles and responsibilities of a Fellow, please visit www.abanet.org/rpte/fellows. Applications are due by June 19, 2009. Fellows will be notified of their appointment by early July. If you have any questions, please feel free to contact Hugh Drake at 217.544.8491 or by e-mail at hdrake@bhslaw.com.

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2009 Real Property, Trust & Estate Law
Law Student Writing Contest

The Real Property Trust and Estate Law Section's 2009 Student Writing Contest is open to all law and LL.M students currently attending an ABA-accredited law school. It is designed to encourage and reward law student writing on real property, trust and estate law subjects of general and current interest. Complete rules as well as the entry form are available online. For more information, please contact Amanda Pauli at paulia@staff.abanet.org. The deadline for submitting essays is June 19, 2009.

The 2009 first place winner will receive $2,500 and a one year membership in the RPTE Section. The winner will also receive free round trip airfare and weekend accommodations to attend the RPTE Fall Leadership Meeting, November 19 - 22, 2009 at the St. Regis Hotel in Dana Point, California (valued at approximately $1,000). In addition, the first place winner's essay will be considered for publication in a future issue of the *Real Property, Trust and Estate Law Journal* and will be announced in *Probate & Property*, the Section magazine. Both the second and third place winners will be announced in *Probate & Property*. The second place winner will receive $1,500, and the third place winner will receive $1,000.